VARIOUS TAX PROPOSALS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 110, S. 487, S. 653, S. 1435, S. 1481, S. 1825, S. 1967, S. 1984, S. 2136, S. 2168, S. 2171, S. 2220, S. 2239

MARCH 24, 28, AND APRIL 1, 1980

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CONTENTS

PUBLIC WITNESSES

COMMUNICATIONS

ADDITIONAL INFORMATION

VARIOUS TAX PROPOSALS

MONDAY, MARCH 24, 1980

U.S. SENATE,
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT GENERALLY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. presiding.

Present: Senators Byrd, Packwood, and Wallop.

[The press releases announcing these hearings and the bills S. 110, S. 487, S. 653, S. 1435, S. 1481, S. 1825, S. 1967, S. 1984, S. 2136, S. 2168, S. 2171, S. 2220, S. 2239 follow:]

[Press release No. H-15, Mar. 13, 1980]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARINGS ON VARIOUS TAX PROPOSALS RECOMMENDED BY THE WHITE HOUSE CONFERENCE ON SMALL BUSINESS

Senator Harry F. Byrd, Jr. (I-Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, announced today that the Subcommittee will hold a series of hearings centering on various tax proposals recommended by the White House Conference on Small Business.

Senator Byrd, along with ten other Senators, is a member of the Small Business Task Force which Majority Leader Robert Byrd had appointed. Senator Gaylord Nelson of Wisconsin is the Task Force Chairman.

The hearings will be held on Monday, March 24, Friday, March 28, and Tuesday, April 1.

The hearing on March 24 will be held in Room 2221 of the Dirksen Senate Office Building, and will begin at 10:00 A.M.

The first hearing on Monday, March 24, will center on the Federal estate tax and its impact on the American family.

Senator Byrd noted that although the estimated receipts in 1980 for all estate and gift taxes is only $5 billion and is less than will be collected from the excise taxes on alcohol and tobacco, the estate and gift taxes have a potential devastating effect on the family and family-owned businesses. "This," Senator Byrd continued, "is because the estate tax is often levied at the precise time that a family has lost the principal wage earner and is undergoing a great financial upheaval. The same holds true for the family business which cannot rapidly recover from the loss of key personnel. If these considerations are not taken into account in the judicious administration of the estate tax, havoc may be wrecked upon the family and small family-owned and operated businesses may be forced into liquidation."

Senator Byrd said that a number of his colleagues share these concerns and have introduced bills to ameliorate or avoid these problems. For example, Senator Wallop has introduced *S. 1984*, which among other things, would eliminate material participation as a requirement for the special valuation of farms and businesses under the estate tax. S. 1984 would also remove the limitation on the marital deduction and raise the annual gift tax exclusion from $3,000 to $6,000.

Senator Nelson, together with Senators Baucus, Heinz and Stewart, have introduced S. 2220, the "Family Business Protection Act of 1980", which is designed to aid the continuation of family businesses during the transition period following the death of a key family member. Senator Nelson, along with Senators Pell, Roth, Cranston, Packwood, Melcher, Thurmond, and Jepsen have also introduced S. 1825 which would increase the unified estate tax credit to $70,700, thereby increasing the estate tax exemption to $250,000.

Senator Byrd said that although a number of other bills amending various estate and gift tax provisions have been introduced, the scheduled hearing will concentrate primarily on S. 1825, S. 1984 and S. 2220.

Witnesses.—Senator Byrd stated that the following witnesses have been scheduled to testify at the hearing.

HON. DONALD LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

A panel consisting of: James Powell, Tax Committee Chairman, National Cattlemen's Association; and Steven Wolf of the National Family Business Council.

A panel consisting of: Frank S. Berall, Co-Chairman, Estate and Gift Tax Committee, American College of Probate Counsel; Dave L. Cornfeld, Vice Chairman for Publications of the American Bar Association's Tax Section; J. Thomas Eubank, Last Retiring Chairman of the American Bar Association's Real Property, Probate and Trust Law Section; and, Edward C. Halbach, Jr., Chairman-elect of the American Bar Association's Real Property, Probate and Trust Law Section.

It is expected that the panel of witnesses will appear on behalf of themselves rather than as representatives of their organizations. Senator Byrd further stated that if public interest in this area of law is sufficiently great, the Subcommittee may consider an additional morning of hearings.

Witnesses scheduled to testify must comply with the following rules:

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

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

(3) The written statement must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

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

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

Written testimony.—The Chairman stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be mailed with five (5) copies by Monday, April 1, 1980, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

[Press Release No. H-17, Mar. 20, 1980]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ANNOUNCES WITNESSES FOR THE HEARING ON PROPOSALS FOR THE ENCOURAGEMENT OF SMALL BUSINESSES THROUGH TAX REFORMS AND CAPITAL FORMATION

Senator Harry F. Byrd, Jr. (I-Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Finance Committee had previously announced that the Subcommittee will hold a series of hearings focusing on the proposals recommended by the White House Conference on Small Business. Today, Senator Byrd announced the format and the witnesses who have been scheduled to testify at the hearings.

The hearings will be held on Friday, March 28 and Tuesday, April 1 in Room 2221 of the Dirksen Senate Office Building, and will begin at 9:00 A.M. each day.

Although the hearings will focus on a number of Senate bills recommended by the White House Conference, Senator Byrd, a member of the Senate Small Business Task Force, emphasized that the witnesses need not restrict their testimony to these particular bills.

"We have invited a series of witnesses, each an expert in his field," said Senator Byrd. "We welcome their comments on matters of importance to the small business community, including the Senate bills, other tax proposals, and current problems in the tax area confronting small businesses which have not been addressed in legislation."

The hearings will focus on the following bills:

S. 487—Provides a credit for investment in originial stock of small businesses.

S. 653—Provides for the non-recognition of gain on the sale of stock if the proceeds are reinvested.

S. 1481—Provide a tax credit for investment in qualifying debentures.
S. 2136—Corporate rate reduction.
S. 1435 and S. 110—Depreciation reform.
S. 2171—Would eliminate the mid-year W-2 form.
S. 2168—Permits subchapter S corporations to have 100 shareholders.
S. 2239—Provides favored tax treatment for certain stock options.
S. 1967—Would permit the establishment of a reserve for the net gain from certain market making activities.

Witnesses.—Senator Byrd stated that panels of experts representing the entire spectrum of small business have been invited to testify. This will include attorneys, accountants, and economists specializing in the servicing of small businesses as well as institutional advocates and operating small businessmen.

Invited to testify on March 28, are: The Department of the Treasury; Mr. Milton Steward, Office of Advocacy, Small Business Administration; Small Business Legislative Council; and National Venture Capital Association.

Among those invited to testify on April 1, include: National Federation of Independent Businessmen; National Association of Small Business Investment Companies; and Wisconsin Manufacturers and Commerce Association.

Witnesses scheduled to testify must comply with the following rules:

(1) A copy of the statement must be filed by the close of business the day before the day the witness is scheduled to testify, together with the full mailing address of the witness.

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

(3) The written statement must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

Written testimony.—The Chairman stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be mailed with five (5) copies by April 30, 1980, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

96TH CONGRESS
1ST SESSION

S. 110

To amend the Internal Revenue Code of 1954 to provide accelerated and simplified depreciation for small business.

IN THE SENATE OF THE UNITED STATES

JANUARY 23 (legislative day, JANUARY 15), 1979

Mr. NELSON (for himself, Mr. FORD, Mr. HUDDLESTON, Mr. PELL, Mr. SASSER, Mr. WEICKER, and Mr. STEWART) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide accelerated and simplified depreciation for small business.

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

SHORT TITLE

SECTION 1. This Act may be cited as the "Small Business Depreciation Reform Act of 1979".

SEC. 2. Section 167 of the Internal Revenue Code of 1954 (relating to depreciation) is amended by adding at the end thereof the following new subsection:

"(q) THREE-YEAR USEFUL LIFE, STRAIGHT-LINE DEPRECIATION.—

"(a) GENERAL RULE.—In the case of a taxpayer who has made an election under this subsection for the taxable year, the term 'reasonable allowance' as used in subsection (a) means (with respect to property which has a useful life of 36 months or more) an allowance based on a useful life of 36 months computed under the straight-line method (within the meaning of subsection (b)(1)).

"(b) $25,000 BASIS LIMITATION.—For purposes of this subsection, the basis (as determined under subsection (g)) of property placed in service during the taxable year shall, to the extent that such basis exceeds $25,000 for the taxable year, not be taken into account.

"(c) ELECTION.—An election under this subsection for any taxable year shall be made at such time, in such manner, and subject to such conditions as may be prescribed by the Secretary by regulations.

"(d) LIMITATION.—

"(1) GENERAL RULE.—Subject to the exception provided by subparagraph (2), the provisions of this section shall not apply to property to which an election under section 179 applies.

"(2) EXCEPTION.—The provisions of subparagraph (1) shall not apply to that portion of the basis of property placed in service during the taxable year which exceeds $25,000 for the taxable year.".

SEC. 3. Subsection (c) of section 46 is amended by adding at the end thereof the following new paragraph:

"(1) APPLICABLE PERCENTAGE IN THE CASE OF 3-YEAR USEFUL LIFE, STRAIGHT-LINE DEPRECIATION.—Notwithstanding subsection (c)(2), in the case of property with respect to which an election under section 167(q) applies, the useful life of any such property for purposes of this subpart shall be the useful life determined without regard to section 167(q).".

EFFECTIVE DATE

SEC. 4. The amendment made by sections 2 and 3 of this Act shall apply in the case of property acquired after the date of enactment of this Act and placed in service in taxable years ending after the date of enactment of this Act.

96TH CONGRESS 1ST SESSION

S. 487

To amend the Internal Revenue Code of 1954 to provide a credit for investment in original issue stock of small businesses.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 26 (legislative day, FEBRUARY 22), 1979

Mr. NELSON (for himself, Mr. STEWART, and Mr. PACKWOOD) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide a credit for investment in original issue stock of small businesses.

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

SECTION 1. SHORT TITLE.

This Act may be cited as the "Small Business Private Investment Act of 1979".

SEC. 2. ALLOWANCE OF CREDIT.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (relating to credits allowable) is amended by inserting immediately before section 45 the following new section:

"SEC. 44D. INVESTMENT IN ORIGINAL ISSUE STOCK OF SMALL BUSINESSES.

"(a) GENERAL RULE.—In the case of an individual who is a citizen or resident of the United States, there is allowed, as a credit against the tax imposed by this chapter for the taxable year, an amount determined under subsection (b) with respect to the adjusted basis (within the meaning of section 1011) of the taxpayer for incentive stock (as defined in subsection (c)) acquired for money during the taxable year.

"(b) AMOUNT OF CREDIT.—

"(1) INDIVIDUALS.—In the case of individuals, the amount of the credit shall, subject to paragraph (2), be equal to the sum of—

"(A) 10 percent of the first $10,000 of such adjusted basis, plus

"(B) 5 percent of any other amount of such adjusted basis.

"(2) INDIVIDUAL CREDIT NOT TO EXCEED $3,000.—In the case of an individual, the credit allowed by subsection (a) for any taxable year shall not exceed $3,000 ($6,000 in the case of a married individual filing a joint return).

"(c) LIMITATIONS.—

"(1) CREDIT NOT ALLOWED TO CERTAIN DEPENDENTS.—No credit shall be allowed under subsection (a) to an individual with respect to whom a personal exemption deduction is allowable for the taxable year to another taxpayer under section 151(e).

"(2) CREDIT NOT ALLOWED IF TAXPAYER CONTROLS CORPORATION.—No credit shall be allowed under subsection (a) with respect to the amount of the adjusted basis of the taxpayer for incentive stock in any corporation if at any time during the taxable year the taxpayer possessed 80 percent or more of the total combined voting power of all classes of stock entitled to vote.

"(3) APPLICATION WITH OTHER CREDITS.—The credit allowed by subsection (a) shall not exceed the tax imposed by this chapter for the taxable year, reduced by the sum of the credits allowable under a section of this part having a lower number or letter designation than this section, other than the credits allowable by sections 31, 39, and 43.

"(4) CERTAIN TAXES NOT CONSIDERED TAXES IMPOSED BY THIS CHAPTER.—For purposes of this section, any tax imposed for the taxable year by section 56 (relating to minimum tax for tax preferences), section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), section 402(e) (relating to tax on lump sum distributions), section 408(f) (relating to additional tax on income from certain retirement accounts), section 531 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), or section 1378 (relating to tax on certain capital gains of subchapter S corporations), and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by this chapter for such year.

"(5) CREDIT NOT ALLOWED IF TAXPAYER ELECTS ROLLOVER.—No credit shall be allowed with respect to amounts paid for incentive stock with respect to which the taxpayer has elected the application of section 1041 (relating to sales of small business stock).

"(d) DEFINITION OF INCENTIVE STOCK.—

"(1) IN GENERAL.—For purposes of this section, the term 'incentive stock' means original issue common or preferred stock registered under section 12 of the Securities Exchange Act of 1934 offered in an unrestricted offer to the public—

"(A) which is issued by a domestic corporation (other than an electing small business corporation as defined in section 1371(b))—

"(i) which does not, for the taxable year in which such stock is offered, have passive investment income (as defined in section 1372(e)(5)(C)) in excess of the limitation set forth in section 1372(e)(5)(A), and

"(ii) the equity capital (within the meaning of the last sentence of section 1244(c)(2)) of which does not exceed $25,000,000 immediately before such offering, and

"(B) which is part of an issue of stock the aggregate sale price of which does not exceed $7,500,000.

"(2) CONTROLLED CORPORATIONS.—In the case of a corporation which is a member of a controlled group of corporations (as defined in section 1563(a)(1)), the equity capital of all members of the controlled group shall be treated, for purposes of paragraph (1)(A) this subsection, as the equity capital of the issuing corporation.

"(3) STOCK ACQUIRED MORE THAN 180 DAYS AFTER ISSUANCE; STOCK ACQUIRED BY UNDER-

WRITER.—No stock shall be treated as incentive stock for purposes of this section if it is first purchased more than 180 days after the date on which it is issued. No acquisition of stock by an underwriter in the ordinary course of his trade or business as an underwriter, whether or not guaranteed, shall be treated as an acquisition for purposes of subsection (a).

"(4) CERTAIN REDEMPTIONS AND REFINANCING ISSUES NOT TREATED AS INCENTIVE STOCK.—An issue of stock which, but for this paragraph, would be treated as incentive stock under this section shall not be treated as incentive stock if, within 180 days before the date of issuance, the issuing corporation (or any other corporation which is a member of the same controlled group of corporations, within the meaning of section 1563, as the issuing corporation) has acquired stock (including acquisition by way of redemption) of the issuing corporation or of any other member of the controlled group with an aggregate purchase price in excess of 10 percent of the aggregate sale price of the issue of incentive stock.

"(e) DISPOSITION OF INCENTIVE STOCK BEFORE IT IS HELD FOR MORE THAN 6 MONTHS.—

"(1) DISPOSITION BEFORE FILING RETURN FOR TAXABLE YEAR OF ACQUISITION.—No credit is allowable under subsection (a) with respect to incentive stock aquired during a taxable year which is not held by the taxpayer on the date established by law for filing a return of tax for that taxable year.

"(2) OTHER PREMATURE DISPOSITIONS.—If during any taxable year incentive stock is disposed of by the taxpayer before the stock has been held by the taxpayer for more than 6 months, then the tax under this chapter for the taxable year shall be increased by the amount of the credit claimed by the taxpayer for any preceding taxable year with respect to the acquisition of such stock.

"(3) EXCEPTIONS.—Paragraphs (1) and (2) of this subsection shall not apply in the case of the disposition by bequest or gift unless—

"(A) the bequest or gift is deductible under section 170 (determined without regard to the limitations contained in subsection (b)), 2055, or 2522, or

"(B) the recipient disposes of the stock before the stock has been held for more than 6 months (including any periods of time during which the stock was held by the original purchaser).".

(b) CLERICAL AMENDMENT.—The table of sections for such subpart is amended by inserting immediately before the item relating to section 45 the following new item:

"Sec. 44D. Investment in original issue stock of small businesses.".

(c) CONFORMING AMENDMENTS.—Subsection (b) of section 6096 of such Code (relating to designation of income tax payments to Presidential Election Campaign Fund) is amended by striking out "and 44C" and inserting in lieu thereof "44C, and 44D".

(d) CREDIT NOT ALLOWED TO ESTATES AND TRUSTS.—Subsection (a) of section 642 of such Code (relating to special rules for credits against tax for estates and trusts) is amended by adding at the end thereof the following new paragraph:

"(3) INVESTMENT IN INCENTIVE STOCK.—An estate or trust shall not be allowed the credit against tax for investment in incentive stock provided by section 44D.".

SEC. 3. EFFECTIVE DATE.

The amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1979, and to stock acquired after the date of enactment of this Act. For purposes of the preceding sentence, stock acquired before January 1, 1980, shall be treated (except for purposes of section 44D (c)(3) and (d) of the Internal Revenue Code of

1954) as acquired on the first day of the first taxable year of the taxpayer beginning after December 31, 1979.

96TH CONGRESS
1ST SESSION

S. 653

To amend the Internal Revenue Code of 1954 to provide for the nonrecognition of gain of the proceeds from the sale of incentive stock if those proceeds are reinvested in such stock, and for an increase in basis for incentive stock held for certain period.

IN THE SENATE OF THE UNITED STATES

MARCH 14 (legislative day, FEBRUARY 22), 1979

Mr. NELSON (for himself, Mr. BAUCUS, Mr. WEICKER, and Mr. HUDDLESTON) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for the nonrecognition of gain of the proceeds from the sale of incentive stock if those proceeds are reinvested in such stock, and for an increase in basis for incentive stock held for certain period.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part III of subchapter O of chapter 1 of the Internal Revenue Code of 1954 (relating to nontaxable exchanges) is amended by adding at the end thereof the following new section:

"SEC. 1041. SALES OF SMALL BUSINESS STOCK.

"(a) NONRECOGNITION OF GAIN.—If small business stock is sold, gain (if any) from such sale shall, at the election of the taxpayer, be recognized only to the extent that the taxpayer's sale price exceeds the cost of small business stock purchased by the taxpayer within 18 months after the date of such sale.

"(b) DEFINITIONS; SPECIAL RULES.—For purposes of this section—

"(1) SMALL BUSINESS STOCK.—The term 'small business stock' means common or preferred stock issued by a domestic corporation or small business investment company (other than an electing small business corporation as defined in section 1371(b))—

"(A) which does not, for the taxable year in which such stock is issued, have passive investment income (as defined in section 1372(e)(5)(C)) in excess of the limitation set forth in section 1372(e)(5)(A), and

"(B) the equity capital (within the meaning of the last sentence of section 1244(c)(2)) of which does not exceed $25,000,000.

(2) CONTROLLED CORPORATIONS.—In the case of a corporation which is a member of a controlled group of corporations (as defined in section 1563(a)(1)), the equity capital of all members of the controlled group shall be treated, for purposes of paragraph (1)(A) of this subsection, as the equity capital of the issuing corporation.

"(3) STOCK ACQUIRED BY UNDERWRITER.—No acquisition of stock by an underwriter in the ordinary course of his trade or business as an underwriter, whether or not guaranteed, shall be treated as a purchase for purposes of subsection (a).

"(4) DEFINITION OF SMALL BUSINESS INVESTMENT COMPANY.—The term 'small business investment company' has the same meaning as when such term is used in title III of the Small Business Investment Company Act of 1958 (15 U.S.C 681 et seq.), except that such term shall not include an electing small business corporation (as defined in section 1371(b)).

"(c) LIMITATIONS.—

"(1) 12-MONTH HOLDING PERIOD.—Subsection (a) shall only apply to gain attributable to sale of small business stock with respect to which the taxpayer's holding period is more than 12 months.

"(2) APPLICATION WITH SECTION 44D.—Subsection (a) shall not apply with respect to any small business stock with respect to which a credit is allowed under section 44D for the taxable year in which it is acquired.

"(d) BASIS OF SMALL BUSINESS STOCK.—The basis of small business stock purchased by the taxpayer during the 18-month period shall be reduced by the amount of gain not recognized solely by reason of the application of subsection (a). If more than one share of small business stock is purchased, such reduction in basis shall be applied to each such share in chronological order of purchase. The amount of the reduction applicable to each share shall be determined by multiplying the maximum gain not to be recognized pursuant to subsection (a) by a fraction the numerator of which is the cost of such share and the denominator of which is the total cost of all such shares.

"(e) STATUTE OF LIMITATIONS.—If during a taxable year a taxpayer sells small business stock at a gain, then—

"(1) the statutory period for the assessment of any deficiency attributable to any part of such gain shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) of—

"(A) the taxpayer's cost of purchasing small business stock which the taxpayer claims results in nonrecognition of any part of such gain,

"(B) the taxpayer's intention not to purchase property within the period specified in paragraph (2), or

"(C) a failure to make such purchase within such period; and

"(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.".

(b) Section 1223 of such Code is amended by redesignating paragraph (12) as paragraph (13) and by inserting a new paragraph (12) as follows:

"(12) In determining the period for which the taxpayer has held small business stock the acquisition of which resulted under section 1041 in the nonrecognition of any part of the gain realized on the sale of small business stock, there shall be included the period for which small business stock with respect to which gain was not recognized had been held, and the period such replacement small business stock was held as of the date of such sale or exchange.".

(c) CLERICAL AMENDMENT.—The table of sections for part III of subchapter O of chaper 1 of such Code is amended by adding at the end thereof the following new item:

"Sec. 1041. Sales of small business stock.".

SEC. 2. The amendments made by this Act shall apply with respect to stock acquired after the date of enactment of this Act.

II

96TH CONGRESS
1ST SESSION

S. 1435

To amend the Internal Revenue Code of 1954 to provide a system of capital recovery for investment in plant and equipment, and to encourage economic growth and modernization through increased capital investment and expanded employment opportunities.

IN THE SENATE OF THE UNITED STATES

JUNE 27 (legislative day, JUNE 21), 1979

Mr. NELSON (for himself, Mr. BENTSEN, Mr. PACKWOOD, and Mr. CHAFEE) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide a system of capital recovery for investment in plant and equipment, and to encourage economic growth and modernization through increased capital investment and expanded employment opportunities.

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

SECTION 1. SHORT TITLE; TABLE OF CONTENTS; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Capital Cost Recovery Act of 1979".

(b) TABLE OF CONTENTS.—

(c) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. CAPITAL COST RECOVERY ALLOWANCE.

(a) IN GENERAL.—Part VI of subchapter B of chapter 1 (relating to itemized deductions for individuals and corporations) is amended by inserting after section 167 the following new section:

"SEC. 168. CAPITAL COST RECOVERY DEDUCTION.

"(a) ALLOWANCE OF DEDUCTION.—In the case of recovery property, there shall be allowed the recovery deduction provided by this section.

"(b) AMOUNT OF DEDUCTION.—

"(1) IN GENERAL.—The recovery deduction for the taxable year shall be the aggregate amount determined by applying to the capital cost of recovery property the applicable percentage determined in accordance with the following table:

"Capital Cost Recovery Table

"If the recovery year is—	The applicable percentage for the class of property is:		
	Class 1	Class 2	Class 3
1	10	20	33
2	18	32	45
3	16	24	22
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		

"(2) TRANSITIONAL APPLICABLE PERCENTAGES.—

"(A) For transitional applicable percentages for additions to capital account of class 1 property before 1984, see subsection (h)(2).

"(B) For transitional applicable percentages for additions to capital account of certain class 2 property before 1984, see subsection (h)(3).

"(c) RECOVERY PROPERTY.—For purposes of this title—

"(1) RECOVERY PROPERTY DEFINED.—Except as otherwise provided in subsection (g), the term 'recovery property' means tangible property (other than land)—

"(A) used in a trade or business, or

"(B) held for the production of income.

"(2) CLASSES OF RECOVERY PROPERTY.—

"(A) CLASSIFICATION TABLE.—The classification of recovery property shall be determined in accordance with following table:

"Classification of Recovery Property

"Class 1	Class 2	Class 3
Buildings and structural components of buildings.	Recovery property not taken into account under class 1 or class 3.	Automobiles, taxis, and light-duty trucks.

"(B) $100,000 LIMIT FOR CLASS 3.—In the case of any taxpayer for any taxable year, the capital cost (for which such year is recovery year 1) taken into account under class 3 shall not exceed $100,000.

"(C) SPECIAL RULES FOR APPLYING THE $100,000 LIMIT.—

"For special rules relating to the $100,000 limit, see subsection (i)(2).

"(d) CAPITAL COST.—

"(1) IN GENERAL.—For purposes of this section, the term 'capital cost' means, with respect to any property, the net addition to capital account for the taxable year (determined without regard to the section 1016(a)(2) adjustment for such year).

"(2) SPECIAL RULES FOR PROPERTY NOT YET PLACED IN SERVICE.—In the case of property which has not been placed in service before the close of the taxable year—

"(A) PAYMENT RULE.—Except as provided in subparagraph (B), the addition to capital account shall be treated as made when payment of an amount is made.

"(B) SELF-CONSTRUCTED PROPERTY.—If the property is constructed (in whole or in part) by the taxpayer, capital cost shall be determined under paragraph (1) without regard to subparagraph (A) of this paragraph.

"(3) AMOUNTS MUST BE FOR PERIOD AFTER 1979.—For purposes of this section, capital cost does not include any amount paid or properly charged to capital account for any period before January 1, 1980.

"(4) SPECIAL RULES.—

"(A) PUBLIC UTILITY PROPERTY ELECTION.—For election to determine capital cost of public utility property by treating advance payments as made when property is placed in service, see subsection (i)(3).

"(B) TRANSITIONAL RULE FOR FISCAL YEAR TAXPAYERS.—For special transitional rule for determining capital cost of fiscal year taxpayers, see subsection (i)(5).

"(e) TAXPAYER MAY DEDUCT LESS THAN FULL ALLOWANCE.—

"(1) IN GENERAL.—For any taxable year the taxpayer may deduct all or any portion of the amount allowable under subsection (a). The deduction for any taxable year may be increased or decreased at any time before the expiration of the period prescribed for making a claim for refund of the tax imposed by this chapter for such taxable year.

"(2) CARRYOVER OF UNUSED DEDUCTIONS.—Any amount allowable for the taxable year by subsection (a) but not deducted for such taxable year shall be carried forward and may be claimed as a deduction for any succeeding taxable year. Any deduction so claimed shall be treated as an addition to the capital cost recovery deduction allowable under subsection (a) for such succeeding taxable year.

"(3) ALLOCATION OF DEDUCTIONS.—If by reason of paragraph (1) the taxpayer deducts less than the amount allowable for any taxable year, the amount deducted shall be apportioned among the taxpayer's recovery property in the same proportion as the amount allowable in respect of the recovery property bears to the total amount allowable in respect of recovery property. A similar rule shall be applied in the case of the allowance of a deduction in a succeeding taxable year under paragraph (2).

"(4) ADJUSTMENTS TO BASIS.—For purposes of section 1016(a)(2), in the case of recovery property the amount allowable under this subtitle for exhaustion, wear and tear, and obsolescence shall be the amount allowable by subsection (a) of this section.

"(f) RECOGNITION OF GAIN OR LOSS AND ADJUSTMENT TO CAPITAL COSTS ON RETIREMENT OR OTHER DISPOSITION.—

"(1) GENERAL RULE.—Gain or loss shall be recognized on the disposition of recovery property, unless nonrecognition is specifically required or permitted by another provision of this chapter.

"(2) MASS ASSET ACCOUNTS.—In lieu of recognizing gain or loss, a taxpayer who maintains mass asset accounts of recovery property may, under regulations prescribed by the Secretary, elect to include in income all proceeds realized on the disposition of such property.

"(3) ADJUSTMENT TO CAPITAL COST.—For purposes of this section, if gain or loss is recognized on the disposition of recovery property, the capital cost of such property shall cease to be capital cost as of the beginning of the taxable year in which such disposition occurs.

"(4) DISPOSITION INCLUDES RETIREMENT.—For purposes of this subsection, the term 'disposition' includes retirement.

"(g) PROPERTY EXCLUDED FROM APPLICATION OF SECTION.—

"(1) CERTAIN PROPERTY EXCLUDED.—The term 'recovery property' does not include—

"(A) property placed in service by the taxpayer before January 1, 1980,

"(B) residential rental property (within the meaning of section 167(j)), and

"(C) property with respect to which the taxpayer—

"(i) is entitled to elect amortization (in lieu of depreciation), and

"(ii) elects such amortization.

"(2) CERTAIN METHODS OF DEPRECIATION.—The term 'recovery property' does not include property if—

63-769 O - 80 - 3

"(A) the taxpayer elects to exclude such property from the application of this section, and

"(B) for the first taxable year for which a deduction would be allowable under this section with respect to such property—

"(i) the property is properly depreciated under the unit-of-production method, the retirement-replacement method, or any other method of depreciation not expressed in a term of years, or

"(ii) the property is a leasehold improvement which is properly depreciated over the term of the leasehold.

"(3) SPECIAL RULE FOR CERTAIN PUBLIC UTILITY PROPERTY.—

"(A) IN GENERAL.—In the case of public utility property (within the meaning of section 167(l)(3)(A)), such property shall be treated as recovery property only if the taxpayer uses a normalization method of accounting.

"(B) USE OF NORMALIZATION METHOD DEFINED.—For purposes of subparagraph (A), a taxpayer uses a normalization method of accounting with respect to any public utility property if both the taxpayer's rates and its operating results on its regulated books of account reflect a tax expense determined by—

"(i) a method of depreciation on the property which is the same as, and

"(ii) a depreciation period for the property which is no shorter than,

the method and period used to determine its depreciation expense on the property for purposes of establishing its cost of service for ratemaking purposes.

"(C) SECRETARY TO PRESCRIBE REGULATIONS.—The Secretary shall provide such regulations as may be necessary or appropriate to prevent the reflection (directly or indirectly) in rates or operating results of an amount of tax expense which is inconsistent with either the depreciation method described in subparagraph (B)(i) or the depreciation period described in subparagraph (B)(ii).

"(4) CERTAIN SALES, LEASES, AND OTHER TRANSACTIONS IN PROPERTY PLACED IN SERVICE BEFORE 1980.—The term 'recovery property' does not include property acquired directly or indirectly from a person who used such property before January 1, 1980, if—

"(A) within 1 year after the property is so acquired, the property is leased back to such person, or

"(B) the person so acquiring the property bears a relationship specified in section 267(b) to the person using such property before January 1, 1980.

"(h) TRANSITIONAL APPLICABLE PERCENTAGES FOR CLASS 1 PROPERTY AND CLASS 2 PROPERTY.—

"(1) IN GENERAL.—The Secretary shall prescribe tables setting forth transitional applicable percentages—

"(A) for additions to capital account of class 1 property before January 1, 1984, and

"(B) for additions to capital account of class 2 property before January 1, 1984.

If for any taxable year for any property there is a transitional applicable percentage, such transitional percentage shall be substituted for the applicable percentage set forth in subsection (b).

"(2) TRANSITIONAL APPLICABLE PERCENTAGES FOR CLASS 1 PROPERTY.—The transitional applicable percentages for class 1 property shall be determined in accordance with the following assigned recovery periods:

"Transitional Recovery Periods for Class 1 Property

"For additions to capital account in—	The transitional applicable percentage shall be based on a capital cost recovery period of the following number of years:
1980	18
1981	16
1982	14
1983	12

"(3) TRANSITIONAL APPLICABLE PERCENTAGES FOR CERTAIN CLASS 2 PROPERTY.—The transitional applicable percentages for class 2 property shall be determined in accordance with the following assigned recovery periods:

"Transitional Recovery Periods for Certain Class 2 Property

"For additions to capital account in—	The transitional applicable percentage shall be based on a capital cost recovery period of the following number of years:
1980	ADR lower limit.
1981	ADR lower limit minus 1 year.
1982	ADR lower limit minus 2 years.
1983	ADR lower limit minus 3 years.

The capital cost recovery period determined under this paragraph shall in no case be less than 5 years.

"(4) ADR LOWER LIMIT DEFINED.—For purposes of paragraph (3), the ADR lower limit for any class of property is the lower limit of the asset depreciation range in effect on June 27, 1979, for such class of property under section 167(m). For purposes of the preceding sentence, lower limits in excess of 9 years shall be treated as equal to 9 years, and any lower limit which is not a whole number of years shall be rounded down to the next lower whole number of years.

"(5) Tables to be similar to subsection (b) table.—The tables prescribed under paragraph (1) for any class of property for any assigned recovery period shall be based on principles similar to those used in the construction of the table under subsection (b) for that class of property.

"(i) Definitions and Special Rules.—For purposes of this section—

"(1) Recovery year 1, etc.—The term 'recovery year 1' means, with respect to any capital cost, the first taxable year for which a deduction with respect to such cost is allowable under subsection (a). The immediately following taxable year shall be recovery year 2, and the taxable years which follow shall be numbered accordingly.

"(2) Special rules for applying the $100,000 limit for class 3 property.—

"(A) In general.—If for any taxable year the capital cost (for which such year is recovery year 1) of automobiles, taxis, and light-duty trucks exceeds $100,000, the taxpayer shall select the items to be treated as class 3 property, but only to the extent of an aggregate capital cost of $100,000. Such a selection, once made, may be changed only in the manner, and to the extent, provided by such regulations.

"(B) MARRIED INDIVIDUALS.—In the case of a husband or wife who files a separate return, the limitation under subparagraph (A) and under subsection (c)(2)(B) shall be $50,000 in lieu of $100,000. This subparagraph shall not apply if the spouse of the taxpayer has no property which may be taken into account as class 3 property (for which this is recovery year 1) for the taxable year of such spouse which ends within or with the taxpayer's taxable year.

"(C) CONTROLLED GROUPS.—In the case of a controlled group, the $100,000 amount specified under subparagraph (A) and under subsection (c)(2)(B) shall be reduced for each component member of the group by apportioning $100,000 among the component members of such group in accordance with their respective amounts of capital cost of automobiles, taxis, and light-duty trucks.

"(D) PARTNERSHIPS.—In the case of a partnership, the limitation contained in subparagraph (A) and in subsection (c)(2)(B) shall apply with respect to the partnership and with respect to each partner.

"(E) CONTROLLED GROUP.—For purposes of this paragraph, the term 'controlled group' has the meaning assigned to such term by section 1563(a), except that the phrase 'more than 50 percent' shall be substituted for the phrase 'at least 80 percent' each place it appears in section 1563(a)(1).

"(3) PUBLIC UTILITY MAY ELECT NOT TO TAKE INTO ACCOUNT ADVANCE PAYMENTS.—

"(A) IN GENERAL.—In the case of public utility property (within the meaning of section 167(l)(3)), the taxpayer may elect to treat all additions to capital account for the period before property is placed in service as made during the taxable year in which the property is placed in service.

"(B) EFFECT OF ELECTION.—An election under subparagraph (A) shall apply to all public utility property of the taxpayer for the taxable year for which the election is made and all subsequent taxable years unless the Secretary consents to a revocation of such election.

"(4) MAKING OF ELECTIONS.—Any election (or selection) under this section shall be made at such time and in such manner as the Secretary may by regulations prescribe.

"(5) TRANSITIONAL RULE FOR DETERMINING CAPITAL COST OF FISCAL YEAR TAXPAYERS.—If—

"(A) the taxpayer's taxable year is a period other than the calendar year, and

"(B) a transitional applicable percentage applies to additions to capital account in any portion of the taxable year,

then the capital cost for such taxable year shall be separately computed for each portion of a calendar year included within the taxable year.

"(j) CROSS REFERENCE.—

"For special rule with respect to certain gain derived from disposition of property the adjusted basis of which is determined with regard to this section, see section 1245."

SEC. 3. CHANGES IN INVESTMENT TAX CREDIT.

(a) APPLICABLE PERCENTAGE.—Subsection (c) of section 46 (relating to qualified investment) is amended by adding at the end thereof the following new paragraph:

"(7) APPLICABLE PERCENTAGE FOR RECOVERY PROPERTY.—Notwithstanding paragraph (2), the applicable percentage for purposes of paragraph (1) shall be—

"(A) in the case of class 1 or class 2 recovery property (within the meaning of section 168), 100 percent, or

"(B) in the case of class 3 recovery property (within the meaning of section 168), 60 percent."

(b) CREDIT FOR EXPENDITURES BEFORE PROPERTY IS PLACED IN SERVICE.—Subsection (d) of section 46 is amended to read as follows:

"(d) QUALIFIED PROGRESS EXPENDITURES.—

"(1) IN GENERAL.—The amount of the qualified investment of any taxpayer for the taxable year (determined under subsection (c) without regard to this subsection) shall be increased by the aggregate of the applicable percentage of each qualified capital cost of the taxpayer for the taxable year.

"(2) QUALIFIED CAPITAL COST.—For purposes of paragraph (2), the term 'qualified capital cost' means the capital cost described in section 168(d)(1) for the taxable year with respect to any property which has not been placed in service before the close of such taxable year if such property, when placed in service, can reasonably be expected to be recovery property which is section 38 property.

"(3) APPLICABLE PERCENTAGE.—For purposes of paragraph (1), the term 'applicable percentage' has the meaning given to such term by subsection (c)(7).

"(4) NO QUALIFIED PROGRESS EXPENDITURES FOR PROPERTY FOR YEAR OF RECAPTURE.—In the case of any property, no qualified progress expenditures shall be taken into account under this subsection for the first taxable year for which recapture is required under section 47(a)(3) with respect to such property, or for any taxable year thereafter."

(c) AMENDMENT OF RECAPTURE RULES.—

(1) IN GENERAL.—Subsection (a) of section 47 (relating to certain dispositions, etc., of section 38 property) is amended by redesignating paragraphs (5), (6), and (7) as paragraphs (6), (7), and (8), respectively, and by inserting after paragraph (4) the following new paragraph:

"(5) SPECIAL RULES FOR RECOVERY PROPERTY.—

"(A) GENERAL RULE.—If during any taxable year section 38 recovery property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the recapture period, then the tax under this chapter for such taxable year shall be increased by the recapture percentage of the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero the qualified investment taken into account with respect to such property.

"(B) RECAPTURE PERCENTAGE.—For purposes of subparagraph (A), the recapture percentage shall be determined in accordance with the following table:

"If the taxable year in which the recovery property ceases to be section 38 property is:	The recovery percentage for each class of property is:	
	Class 1 and Class 2	Class 3
The taxable year in which placed in in service	100 percent	100 percent.
The first taxable year after the year in which placed in service	80 percent	66 percent.
The second taxable year after the year in which placed in service	60 percent	33 percent.
The third taxable year after the year in which placed in service	40 percent	0 percent.
The fourth taxable year after the year in which placed in service	20 percent	0 percent.

"(C) DEFINITIONS AND SPECIAL RULES.—

"(i) SECTION 38 RECOVERY PROPERTY.—For purposes of this paragraph, the term 'section 38 recovery property' means any section 38 property which is recovery property (within the meaning of section 168).

"(ii) RECAPTURE PERIOD.—For purposes of this paragraph, the term 'recapture period' means, with respect to any property, the period consisting of the taxable year in which such property is placed in service and the 4 succeeding taxable years (the 2 succeeding taxable years in the case of class 3 property).

"(iii) CLASSIFICATION OF PROPERTY.—For purposes of this paragraph, property shall be classified as provided in section 168.

"(iv) PARAGRAPH (1) NOT TO APPLY.—Paragraph (1) shall not apply with respect to any recovery property."

(2) TECHNICAL AMENDMENTS.—

(A) Subparagraph (D) of section 47(a)(3) is amended—

(i) by striking out "paragraph (1), paragraph (1)" and inserting in lieu thereof "paragraph (1) or (5), as the case may be, such paragraph", and

(ii) by striking out "PARAGRAPH (1)" in the subparagraph heading and inserting in lieu thereof "PARAGRAPH (1) OR (5)".

(B) Paragraph (6) of section 47(a) (as redesignated by paragraph (1)) is amended by striking out "paragraph (1) or (3)" and inserting in lieu thereof "paragraph (1), (3), or (5)".

(C) Subparagraph (B) of section 47(a)(7) (as redesignated by paragraph (1)) is amended by striking out "paragraph (5)" and inserting in lieu thereof "paragraph (6)".

(d) AMENDMENT OF SECTION 48.—The last sentence of section 48(a)(1) (defining section 38 property) is amended by striking out "includes only property" and inserting in lieu thereof "includes only recovery property and any other property".

SEC. 4. AMENDMENTS RELATED TO DEPRECIATION.

(a) RECOVERY DEDUCTION TREATED AS DEPRECIATION.—Subsection (a) of section 167 (relating to depreciation) is amended by adding at the end thereof the following new sentence: "In the case of recovery property (within the meaning of section 168), the recovery deduction allowable under section 168 shall be deemed to constitute the reasonable allowance provided by this section, and such property shall be considered for purposes of this title as property of a character subject to the allowance provided under this section."

(b) NO ADDITIONAL FIRST-YEAR DEPRECIATION FOR RECOVERY PROPERTY.—Paragraph (1) of section 179(d) (defining section 179 property) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(D) which is not recovery property (within the meaning of section 168)."

(c) TERMINATION OF CLASS LIFE SYSTEM.—Subsection (m) of section 167 (relating to class lives) is amended by adding at the end thereof the following new paragraph:

"(4) TERMINATION.—This subsection shall not apply with respect to property placed in service after December 31, 1979."

SEC. 5. DISPOSITION OF RECOVERY PROPERTY SUBJECT TO RECAPTURE UNDER SECTION 1245.

Paragraph (3) of section 1245(a) (defining section 1245 property) is amended by striking out "or" at the end of subparagraph (C), by striking out the period at the end of subparagraph (D) and inserting in lieu thereof ", or", and by adding at the end thereof the following new subparagraph:

"(E) recovery property (within the meaning of section 168)."

SEC. 6. MINIMUM TAX AMENDMENT.

Subsection (a) of section 57 (defining items of tax preference) is amended by inserting after paragraph (11) the following new paragraph:

"(12) CAPITAL COST RECOVERY DEDUCTION.—

"(A) IN GENERAL.—With respect to each property which is class 1 or class 2 recovery property (as determined under section 168) and which is subject to a lease, the amount (if any) by which the recovery deduction allowed for the taxable year is greater than the straight-line capital cost recovery amount determined in accordance with subparagraph (B).

"(B) STRAIGHT-LINE CAPITAL COST RECOVERY AMOUNT.—For purposes of this paragraph, the straight-line capital cost recovery amount shall be the amount of the depreciation deduction which would have been allowed for the taxable year had the taxpayer depreciated the property, beginning with the middle of the taxable year in which placed in service, under the straight-line method for each year of its useful life assuming—

"(i) a useful life of 10 years in the case of class 1 recovery property, and

"(ii) a useful life of 5 years in the case of class 2 recovery property.

"(C) LIMITATIONS.—

"(i) CORPORATIONS.—This paragraph shall not apply to any taxpayer which is a corporation (other than an electing small business corporation as defined in section 1371(b)) and a personal holding company (as defined in section 542).

"(ii) PROPERTY MANUFACTURED OR PRODUCED BY TAXPAYER.—This paragraph shall not apply with respect to any property which is manufactured or produced by the taxpayer.

"(D) PARAGRAPHS (2) AND (3) DO NOT APPLY TO RECOVERY PROPERTY.—Paragraphs (2) and (3) shall not apply to recovery property (within the meaning of section 168)."

SEC. 7. TECHNICAL AMENDMENTS.

(a) EARNINGS AND PROFITS.—

(1) Subsection (k) of section 312 is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) EXCEPTION FOR RECOVERY DEDUCTION.—If for any taxable year a recovery deduction is allowable under section 168 with respect to any recovery property, then the adjustment to earnings and profits for depreciation of such property for such year shall be the amount so allowable (but not in excess of the

63-769 O - 80 - 4

straight-line capital cost recovery amount determined under section 57(a)(12)(B))."

(2) The paragraph heading of paragraph (2) of section 312(k) is amended to read as follows:

"(2) EXCEPTION FOR CERTAIN METHODS OF DEPRECIATION.—".

(b) AMENDMENT OF SECTION 381.—Subsection (c) of section 381 is amended by adding at the end thereof the following new paragraph:

"(27) UNUSED DEDUCTIONS UNDER SECTION 168.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 168, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 168 in respect of the distributor or transferor corporation."

(c) AMENDMENT OF SECTION 383.—Section 383 (relating to special limitations on certain carryovers) is amended by striking out "and to any net capital loss" and inserting in lieu thereof "to any unused deductions under section 168(e), and to any net capital loss".

SEC. 8. EFFECTIVE DATE.

The amendments made by this Act shall apply to taxable years ending after December 31, 1979.

II

96TH CONGRESS
1ST SESSION

S. 1481

To amend the Internal Revenue Code of 1954 to provide a credit against tax for investment in small business participating debentures, and to provide additional tax incentives for the issuance of such debentures.

IN THE SENATE OF THE UNITED STATES

JULY 11 (legislative day, JUNE 21), 1979

Mr. WEICKER (for himself, Mr. BAUCUS, Mr. HATCH, and Mr. HAYAKAWA) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide a credit against tax for investment in small business participating debentures, and to provide additional tax incentives for the issuance of such debentures.

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

SECTION 1. ALLOWANCE OF CREDIT FOR INVESTMENT IN SMALL BUSINESS PARTICIPATING DEBENTURE.

(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (relating to credits allowable) is amended by inserting immediately before section 45 the following new section:

"SEC. 44D. INVESTMENT IN SMALL BUSINESS PARTICIPATING DEBENTURE.

"(a) GENERAL RULE.—In the case of a taxpayer who is a United States person there is allowed, as a credit against the tax imposed by this chapter for the taxable year, an amount equal to the lesser of—

"(1) the product of—

"(A) 1/2 of 1 percent of the proceeds of any small business participating debenture which is acquired by the taxpayer during the taxable year for money from the small business issuing such debentures, multiplied by

"(B) the number of years ending after the date of acquisition and before the maturity date of the debenture, or

"(2) 5 percent of the proceeds of any such debenture.

"(b) LIMITATIONS.—

"(1) MAXIMUM DOLLAR AMOUNT.—The credit allowed by subsection (a) for any taxable year shall not exceed $5,000 ($10,000 in the case of a joint return).

"(2) CREDIT NOT ALLOWED FOR DEBENTURES ISSUED BY A RELATED PARTY.—No credit is allowable under subsection (a) with respect to a small business participating debenture issued by a small business in which the taxpayer has an interest. For purposes of this subsection, a taxpayer shall be considered as having an interest in the issuer of a small business participating debenture if—

"(A) in the case of a small business participating debenture issued by a corporation, the taxpayer is considered, under section 318, to own—

"(i) 10 percent or more in value of the stock, or

"(ii) stock which represents 10 percent or more of the voting rights

in the corporation or in a corporation which is a member of the same controlled group of corporations (within the meaning of section 1563(a)), or

"(B) in the case of a small business participating debenture issued by a small business not organized as a corporation, the taxpayer owns, or is considered to own (under regulations prescribed by the Secretary similar to the regulations prescribed under section 318), more than 10 percent of the profits or capital in the business.

"(3) Debentures issued by person holding taxpayer's debentures.—If—

"(A) a taxpayer acquires a small business participating debenture from a small business, and

"(B) such small business or a person with an interest in such small business acquired, before the acquisition described in subparagraph (A), any such debenture from the taxpayer or any small business which the taxpayer has an interest in,

no credit is allowable under subsection (a) with respect to that amount of the proceeds of the debenture acquired by the taxpayer which is equal to the amount of the proceeds of any such debenture acquired from the taxpayer or the small business in which the taxpayer has an interest.

"(4) APPLICATION WITH OTHER CREDITS.—The credit allowed by subsection (a) shall not exceed the tax imposed by this chapter for the taxable year, reduced by the sum of the credits allowable under a section of this part having a lower number or letter designation than this section other than the credits allowable by sections 31, 39, and 43.

"(5) CERTAIN TAXES NOT CONSIDERED TAXES IMPOSED BY THIS CHAPTER.—For purposes of this section, any tax imposed for the taxable year by section 55 (relating to alternative minimum tax for taxpayers other than corporations), section 56 (relating to minimum tax for tax preferences), section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), section 402(e) (relating to tax on lump sum distributions), section 408(f) (relating to additional tax on income from certain retirement accounts), section 409(c) (relating to additional tax on retirement bonds), section 531 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), or section 1378 (relating to tax on certain capital gains of subchapter S corporations), and any additional tax imposed for the taxable year by section 1351(b)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by this chapter for such year.

"(c) CARRYOVER OF UNUSED CREDIT.—

"(1) ALLOWANCE OF CREDIT.—If the amount of the credit determined under this section for any taxable year exceeds the limitation provided by subsection (b) (1) or (4) for such taxable year (hereinafter in this subsection referred to as the 'unused credit year'), such excess shall be a small business participating debenture credit carryover to each of the 7 taxable years following the unused credit year, and shall be added to the amount allowable as a credit by this section for such years. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 7 taxable years to which such credit may be carried, and then to each of the other 6 taxable years to the extent that, because of the limitation contained in paragraph (2), such unused credit may not be added for a prior taxable year to which such unused credit may be carried.

"(2) LIMITATION.—The amount of the unused credit which may be added under paragraph (1) for any preceding or succeeding taxable year shall not exceed the amount by which the limitation provided by subsection (b) (1) or (4) for such taxable year exceeds the sum of—

"(A) the credit allowable under this section for such taxable year, and

"(B) the amounts which, by reason of this subsection, are added to the amount allowable for such taxable year and which are attributable to taxable years preceding the unused credit year.

"(d) PREMATURE DISPOSITION OF SMALL BUSINESS PARTICIPATING DEBENTURE.—

"(1) DISPOSITION BEFORE FILING RETURN FOR TAXABLE YEAR OF ACQUISITION.—No credit is allowable under subsection (a) with respect to a small business participating debenture acquired during the taxable year which is not held by the taxpayer on the date established by law for filing a return of tax for that taxable year, if, as of that date, the taxpayer has disposed of the debenture after holding it for less than 12 months and 1 day.

"(2) OTHER PREMATURE DISPOSITIONS.—

"(A) IN GENERAL.—If during any taxable year a small business participating debenture is disposed of, or under paragraph (3) or (4) is treated as having been disposed of, by the taxpayer before the maturity date of the debenture, then the tax under this chapter for the taxable year shall be increased by an amount which bears the same ratio to the amount of the credit allowed to the taxpayer for any preceding taxable year with respect to the acquisition of such debenture as the number of months between the date of disposition and the date of maturity of the debenture bears to the number of months between the date of acquisition and the date of maturity of the debenture.

"(B) CARRYOVER ADJUSTED.—In the case of any disposition described in paragraph (A), any carryover under subsection (c) shall be adjusted by reason of such disposition.

"(3) BECOMING A RELATED PARTY TREATED AS DISPOSITION.—For purposes of this subsection, a taxpayer shall be treated as having disposed of a small business participating debenture whenever the taxpayer becomes a related party (within the meaning of subsection (b)(2)) to the issuer.

"(4) CERTAIN ACTIONS BY ISSUER TREATED AS DISPOSITION BY TAXPAYER.—If the issuer of the small business participating debenture—

"(A) issues, during the 2-year period beginning on the date of issuance of such debenture, securities which are subject to regulation by the Securities and Exchange Commission,

"(B) ceases, during any taxable year of the issuer beginning before the date of maturity of the debenture, to derive more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks and securities (determined under rules similar to the rules provided in section 1244(c)(1)(C) and (c)(2) (A) and (B)), or

"(C) is, during any taxable year of the issuer beginning before the date of maturity of the debenture, a party to a reorganization described in subparagraphs (A) through (D) of section 368(a)(1)

then, for purposes of this subsection, the taxpayer shall be treated as having disposed of the small business participating debenture on the last day of the taxable year of the taxpayer (i) during which such securities are issued or (ii) in which the taxable year of the issuer described in subparagraph (B) or (C) ends. For purposes of subparagraph (C), the Secretary may, to the extent necessary, prescribe regulations (which are based on principles similar to the principles which apply under section 368(a)(1)) which shall apply in the case of a reorganization (or similar transaction) involving a trade or business which is not organized as a corporation.

"(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) IN GENERAL.—The term 'small business participating debenture' means a written debt instrument issued by a qualified small business which—

"(A) is a general obligation of the qualified small business,

"(B) bears a stated rate of interest not less than the rate prescribed by the Secretary under section 483(c)(1)(B), "(C) has a fixed maturity,

"(D) grants no voting or conversion rights in the qualified small business to the purchaser, and

"(E) provides for the payment of a share of the total earnings of the issuer.

"(2) QUALIFIED SMALL BUSINESS.—

"(A) IN GENERAL.—The term 'qualified small business' means any domestic trade or business (whether or not incorporated)—

"(i) the equity capital of which does not exceed $25,000,000 immediately before the small business participating debenture is issued,

"(ii) with respect to which, at the time the small business participating debenture is issued, the face value of all outstanding small business participating debentures issued (including such debenture) does not exceed $1,000,000, and

"(iii) which has no securities outstanding which are subject to regulation by the Securities and Exchange Commission at the time of issuance of the small business participating debenture.

"(B) CONTROLLED GROUPS.—For purposes of determining under subparagraph (A) the equity capital and outstanding small business participating debentures of—

"(i) a member of the same controlled group of corporations (within the meaning of section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a)(1)), and

"(ii) a member of a group of trades or businesses (whether or not incorporated) which are under common control, as determined under regulations prescribed by the Secretary which are based on principles similar to the principles which apply under clause (i),

the equity capital and outstanding debentures of all members of such group shall be taken into account.

"(C) EQUITY CAPITAL.—For purposes of this paragraph—

"(i) CORPORATION.—In the case of a corporation, the term 'equity capital' means the aggregate amount of money and other property (taken into account in an amount, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject or which were assumed by the corporation at such time) received by the corporation for stock, as a contribution to capital, and as paid in surplus, other than amounts received as the proceeds of small business participating debentures issued by the corporation.

"(ii) NONCORPORATE BUSINESS.—In the case of a trade or business which is not organized as a corporation, equity capital shall be determined under regulations prescribed by the Secretary which are based on principles similar to the principles which apply under clause (i).

"(3) SUBCHAPTER S CORPORATIONS.—In the case of an electing small business corporation (as defined in section 1371)—

"(A) the amount of the credit allowable under subsection (a) for the taxable year shall be apportioned among the persons who are shareholders of such corporation on the last day of the taxable year, and

"(B) the dollar limitation contained in subsection (b)(1) shall apply with respect to such corporation and with respect to each shareholder.".

(b) CLERICAL AMENDMENT.—The table of sections for such subpart is amended by inserting immediately before the item relating to section 45 the following new item:

"Sec. 44D. Investment in small business participating debenture.".

(c) CONFORMING AMENDMENTS.—

(1) Subsection (b) of section 6096 of such Code (relating to designation of income tax payments to Presidential Election Campaign Fund) is amended by striking out "and 44C" and inserting in lieu thereof "44C, and 44D".

(2) Paragraph (3) of section 55(c) of such Code (relating to credits against alternative minimum tax for taxpayers other than corporations) is amended by redesignating subparagraph (D) as (E) and inserting after subparagraph (C) the following new subparagraph:

"(D) SMALL BUSINESS PARTICIPATING DEBENTURE CREDIT.—For purposes of determining under section 44D(c) the amount of any small business participating debenture credit carryover to any other taxable year, the amount of the limitation under section 44D(c)(2) for the current taxable year shall be deemed to be—

"(i) the amount of the credit allowable under section 44D for the current taxable year without regard to this subparagraph, reduced by

"(ii) the amount equal to the lesser of (I) the amount of the credit allowable under section 44D for the current taxable year without regard to this subparagraph, or (II) the net tax imposed by this section for the current taxable year reduced by the sum of the amounts of reduction described in clause (ii) of subparagraphs (A), (B), and (C).".

(d) TREATMENT OF ORIGINAL ISSUE DISCOUNT INTEREST.—Section 1232 of such Code (relating to bonds and other evidences of indebtedness) is amended by adding at the end thereof the following new subsection:

"(h) SMALL BUSINESS PARTICIPATING DEBENTURES.—Any small business participating debenture (as defined in section 44D(e)) issued by a trade or business other than a corporation shall be treated, for purposes of this section, as if it were issued by a corporation.".

SEC. 2. TREATMENT OF INCOME, GAINS, LOSSES, ETC. ON SMALL BUSINESS PARTICIPATING DEBENTURES.

(a) CAPITAL GAINS TREATMENT OF EARNINGS.—Part IV of subchapter P of chapter 1 of the Internal Revenue Code of 1954 (relating to special rules for determining capital gain and loss) is amended by adding at the end thereof the following new section:

"SEC. 1256. EARNINGS DISTRIBUTIONS UNDER SMALL BUSINESS PARTICIPATING DEBENTURES.

"(a) IN GENERAL.—For purposes of this subtitle, and except as provided in subsection (b), amounts actually paid during the taxable year to a taxpayer in respect of a small business participating debenture (as defined in section 44D(e)) which constitute the distribution of a share of the earnings of the issuer, shall be treated as long-term capital gain.

"(b) SUBSECTION (a) NOT TO APPLY.—

"(1) CREDIT DISALLOWED.—

"(A) IN GENERAL.—If no credit is allowable under section 44D(b)(2) with respect to any debenture, subsection (a) shall not apply to any distribution in connection with the debenture for any taxable year.

"(B) PARTIAL DISALLOWANCE OF CREDIT.—If any amount of the credit is not allowable under section 44D(b)(3), subsection (a)

63-769 O - 80 - 5

shall not apply to that portion of the amount constituting a distribution of a share of earnings in any taxable year which bears the same ratio to the total amount constituting a distribution of a share of earnings as the amount of the proceeds of the debenture with respect to which the credit is not so allowable bears to the total proceeds of the debenture.

"(2) PREMATURE DISPOSITION.—If the taxpayer is treated as having disposed of the small business participating debenture under section 44D(d) (3) or (4), subsection (a) shall not apply to any such distribution in connection with such debenture for the taxable year of the disposition and any subsequent taxable year.

"(3) SECTION 301 TO APPLY.—

"(A) IN GENERAL.—Any amount to which subsection (a) does not apply by reason of paragraph (1) or (2) shall be treated by the taxpayer and the issuer in the same manner as a distribution of property to which section 301 applies.

"(B) NON-CORPORATE BUSINESS.—In the case of a trade or business which is not organized as a corporation, such amounts shall be treated in a manner determined under regulations prescribed by the Secretary which are based on principles similar to the principles which apply under subparagraph (A).

"(c) SPECIAL RULES FOR PAYMENTS.—For purposes of this section and section 163(e)—

"(1) TIME FOR PAYMENT.—Payments under subsection (a) shall be deemed to have been made on the last day of a taxable year if the payment is on account of such taxable year and is made not later than the time prescribed by law for the filing of the return for such taxable year (including extensions thereof).

"(2) ORDER OF PAYMENTS.—Any payment in respect of a small business participating debenture shall be treated first as a payment of interest until all interest required to be paid under the debenture for such taxable year and preceding taxable years is paid and then as a payment of earnings.".

(b) CLERICAL AMENDMENT.—The table of sections for such part is amended by adding at the end thereof the following new item:

"Sec. 1256. Earnings distributions under small business participating debentures.".

(c) LOSSES ON SMALL BUSINESS PARTICIPATING DEBENTURES TREATED AS ORDINARY LOSS.—Section 1244 of such Code (relating to losses on small business stock) is amended by adding at the end of subsection (d) the following new paragraph:

"(5) SMALL BUSINESS PARTICIPATING DEBENTURES TREATED SAME AS SECTION 1244 STOCK.—

"(A) IN GENERAL.—For purposes of this section, any loss on a small business participating debenture issued to an individual shall be treated as if it were a loss on section 1244 stock issued to that individual.

"(B) SUBPARAGRAPH (A) NOT TO APPLY.—

"(i) CREDIT DISALLOWED.—

"(I) IN GENERAL.—If no credit is allowable under section 44D(b)(2) with respect to any debenture, subparagraph (A) shall not apply to any loss in connection with the debenture for any taxable year.

"(II) PARTIAL DISALLOWANCE OF CREDIT.—If any amount of the credit is not allowable under section 44D(b)(3), subsection (a) shall not apply to that portion of the loss in any taxable year which bears the same ratio to the total loss as the amount of the proceeds of the debenture with respect to which the credit is not so allowable bears to the total proceeds of the debenture.

"(ii) PREMATURE DISPOSITION.—If the taxpayer is treated as having disposed of the small business participating debenture under section 44D(d) (3) or (4), subparagraph (A) shall not apply to any such loss occurring during the taxable year of such disposition or any subsequent taxable year.".

(d) INTEREST DEDUCTIBLE AS INTEREST EXPENSE.—Section 163 of such Code (relating to interest) is amended by redesignating subsection (e) as (f) and by inserting after subsection (d) the following new subsection:

"(e) INTEREST AND OTHER AMOUNTS PAID ON SMALL BUSINESS PARTICIPATING DEBENTURE.—

"(1) IN GENERAL.—For purposes of this section (other than subsection (d)), amounts paid as interest, and amounts paid as a share of earnings, on a small business participating debenture (as defined in section 44D(e)) shall be treated as interest.

"(2) PARAGRAPH (1) NOT TO APPLY.—

"(A) CREDIT DISALLOWED.—

"(i) IN GENERAL.—If no credit is allowable under section 44D(b)(2) with respect to any debenture, subsection (a) shall not apply to any amount paid as a share of earnings in connection with the debenture for any taxable year.

"(ii) PARTIAL DISALLOWANCE OF CREDIT.—If any amount of the credit is not allowable under section 44D(b)(3), subsection (a) shall not apply to that portion of the amount paid as a share of earnings in any taxable year which bears the same ratio to the total amount paid as a share of earnings as the amount of the proceeds of the debenture with respect to which the credit is not so allowable bears to the total proceeds of the debenture.

"(B) PREMATURE DISPOSITION.—If the taxpayer is treated as having disposed of the small business participating debenture under section 44D(d) (3) or (4), paragraph (1) shall not apply to any amount paid as a share of earnings during the taxable year of such disposition or any subsequent taxable year.".

SEC. 3. EFFECTIVE DATE.

(a) IN GENERAL.—Except as provided in subsection (b), the amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1979, and to small business participating debentures acquired after the date of enactment of this Act. For purposes of the preceding sentence, small business participating debentures acquired after the date of the enactment of this Act and before January 1, 1980, shall be treated (except for purposes of section 44D(d) of the Internal Revenue Code of 1954) as acquired on the first day of the first taxable year of the taxpayer beginning after December 31, 1979.

(b) PROCEEDS USED TO REPAY LOANS.—The amendments made by this Act shall not apply to any small business participating debenture issued before or during calendar year 1980 if the proceeds of such debenture are used to repay any loan of the issuing small business other than a loan—

(1) with a stated rate of interest in excess of the prevailing rate of interest for businesses in the area in which such small business is located, and

(2) secured by the inventory or accounts receivable of such small business.

II

96th CONGRESS
1st Session

S. 1825

To amend the Internal Revenue Code of 1954 to adjust the unified credit against estate and gift taxes to take into account the rate of inflation.

IN THE SENATE OF THE UNITED STATES

September 26 (legislative day, June 21), 1979

Mr. Nelson (for himself, Mr. Pell, Mr. Roth, Mr. Cranston, and Mr. Packwood) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to adjust the unified credit against estate and gift taxes to take into account the rate of inflation.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Estate Tax Adjustment Act of 1979".

Sec. 2. (a) subsection (a) of section 2010 of the Internal Revenue Code of 1954 (relating to unified credit against estate tax) is amended by striking out "$47,000" and inserting in lieu thereof "$70,700".

(b)(1) The table contained in subsection (b) of such section 2010 is amended—

(A) by striking out "38,000" in the item relating to 1979 and inserting in lieu thereof "48,200";

(B) by striking out "42,500" in the item relating to 1980 and inserting in lieu thereof "58,900"; and

(C) by striking out "$47,000" in the caption thereof and inserting in lieu thereof "$70,700".

(2) The heading for such subsection (b) is amended by striking out "$47,000" and inserting in lieu thereof "$70,700".

(c)(1) Subsection (a) of section 6018 of such Code is amended by striking out "$175,000" in paragraph (1) and inserting in lieu thereof "$250,000".

(2) Paragraph (3) of section 6018 of such Code is amended—

(A) by striking out "$175,000" in subparagraphs (C) and (D) and inserting in lieu thereof "$250,000";

(B) by striking out "$147,000" in subparagraph (C) thereof and inserting in lieu thereof "$179,500"; and

(C) by striking out "$161,000" in subparagraph (D) thereof and inserting in lieu thereof "$213,000".

SEC. 3. (a) Subsection (a) of section 2505 of the Internal Revenue Code of 1954 (relating to unified credit against gift tax) is amended by striking out "$47,000" in paragraph (1) and inserting in lieu thereof "$70,700".

(b)(1) The table contained in subsection (b) of such section 2505 is amended—

(A) by striking out "38,000" and inserting in lieu thereof "48,200";

(B) by striking out "42,500" and inserting in lieu thereof "58,900"; and

(C) by striking out "$47,000" in the caption thereof and inserting in lieu thereof "$70,700".

(2) The heading of such subsection (b) is amended by striking out "$47,000" and inserting in lieu thereof "$70,700".

SEC. 4. (a) The amendments made by the first section of this Act shall apply to the estates of decedents dying after December 31, 1978.

(b) The amendments made by section 2 of this Act shall apply to gifts made after December 31, 1978.

II

96TH CONGRESS
1ST SESSION

S. 1967

To amend the Internal Revenue Code of 1954 to allow a corporation which deals in securities to establish a reserve for the net gain from certain market making activities.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 1 (legislative day, OCTOBER 15), 1979

Mr. NELSON introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to allow a corporation which deals in securities to establish a reserve for the net gain from certain market making activities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Capital Formation Incentive Act of 1979".

SEC. 2. (a) Part VIII of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to special deductions for corporations) is amended by adding at the end thereof the following new section:

"SEC. 251. MARKET MAKING RESERVE.

"(a) ALLOWANCE OF DEDUCTION.—In the case of a corporation which is engaged in market making activities during the taxable year, there shall be allowed as a deduction for such taxable year an amount equal to the amount of additions to a reserve for gains from such market making activities during such taxable year.

"(b) LIMITATIONS.—

"(1) AVERAGE POSITION.—No deduction shall be allowed under subsection (a) if the amount of the additions to the reserve for the taxable year exceeds 30 percent of the fair market value of average positions carried for market making activities by the taxpayer during the taxable year.

"(2) $1,000,000 RESERVE.—No deduction shall be allowed under subsection (a) for any taxable year for any addition to the reserve, if, as of the close of the taxable year (after adjustment under subsection (c)), the reserve exceeds $1,000,000.

"(3) TAXABLE INCOME.—The amount of the deduction allowed under subsection (a) shall not exceed the taxable income of the taxpayer for the taxable year (determined without regard to this section).

"(c) ADJUSTMENTS TO RESERVE.—

"(1) REQUIRED WITHDRAWALS FROM RESERVE.—At the close of each taxable year, the taxpayer shall withdraw from the reserve an amount equal to the excess of—

"(A) the amount of the additions to the reserve for which a deduction was allowed for the 10th taxable year preceding such taxable year, over

"(B) any withdrawal from the reserve during any preceding taxable year under paragraph (2) which was treated as a withdrawal of any additions made to the reserve during such 10th preceding taxable year.

"(2) ADDITIONAL WITHDRAWALS.—At the close of the taxable year, the taxpayer may withdraw from the reserve any amount in excess of the amount described in paragraph (1). Any such withdrawal shall be treated as a withdrawal of additions to the reserve in the order in which such additions were made to the reserve, beginning with the earliest such addition.

"(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) MARKET MAKING ACTIVITIES.—The term 'market making activities' means the purchase and sale of over-the-counter equity securities by a dealer in securities, or any specialist permitted to act as a dealer, who holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell over-the-counter equity securities for his own account on a regular or continuous basis.

"(2) GAIN FROM MARKET MAKING ACTIVITIES.—The term 'gain from market making activities' means the net gain realized from the sale or exchange of over-the-counter equity securities—

"(A) of corporations which, on the last day of the taxable year of the taxpayer preceding the taxable year of the sale or exchange, had $25,000,000 or less of equity securities in such corporation outstanding, and

"(B) which are held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

"(3) OVER-THE-COUNTER EQUITY SECURITIES.—The term 'over-the-counter equity securities' means any equity security not traded on a registered security exchange.

"(4) AVERAGE POSITIONS FOR MARKET MAKING ACTIVITIES.—The term 'average position for market making activities' means the average monthly inventory positions for over-the-counter equity securities of the taxpayer for the taxable year.

"(5) CONTROLLED GROUP OF CORPORATIONS.—For purposes of applying the limitations under subsection (b), all members of the same controlled group of corporations shall be treated as one corporation. In any such case, the deduction allowable by subsection (a) for each such member shall be its proportionate share of net gain from market making activities taken into account in determining the amount of the deduction. For purposes of this paragraph, the term 'controlled group of corporations' has the meaning given to such term by section 1563(a), except that 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a)(1).

"(6) CORPORATE ACQUISITIONS.—In the case of the acquisition described in section 381(a) (1) or (2) of the assets of a corporation by another corporation, the acquiring corporation shall not succeed to any reserve established under this section.".

(b) Section 81 of such Code (relating to certain increases in suspense accounts) is amended—

(1) by striking out "There" and inserting "(a) There"; and

(2) by adding at the end thereof the following new subsection:

"(b) WITHDRAWALS FROM MARKET MAKING RESERVES.—There shall be included in gross income for the taxable year the amount of any withdrawal from any market making reserve under section 251(c).".

(c)(1) The table of sections for part VII of subchapter B of chapter 1 of such Code is amended by inserting at the end thereof the following new item:

"Sec. 251. Market making reserve.".

(2)(A) The heading for section 81 of such Code is amended by inserting "OR REDUCTIONS IN MARKET MAKING RESERVES" after "ACCOUNTS".

(B) The item relating to section 81 in the table of sections for part II of subchapter B of chapter 1 of such Code is amended by inserting "or reduction in market making reserves" after "accounts".

SEC. 3. The amendments made by section 2 of this Act shall apply to taxable years beginning after December 31, 1979.

II

96TH CONGRESS
1ST SESSION

S. 1984

To amend the Internal Revenue Code of 1954 to provide an unlimited marital estate and gift tax deduction, to modify provisions relating to special valuation of certain farm and other real property, and for other purposes.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 6 (legislative day, NOVEMBER 5), 1979

Mr. WALLOP introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide an unlimited marital estate and gift tax deduction, to modify provisions relating to special valuation of certain farm and other real property, and for other purposes.

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

SECTION 1. SHORT TITLE.

This Act may be cited as the "Estate and Gift Tax Amendments of 1979".

SEC. 2. UNLIMITED MARITAL DEDUCTION.

(a) ESTATE TAX DEDUCTION.—

63-769 O - 80 - 6

(1) In general.—Section 2056 of the Internal Revenue Code of 1954 (relating to bequests, etc. to surviving spouses) is amended—

(A) by striking out subsection (c) and redesignating subsection (d) as subsection (c); and

(B) by striking out "subsections (b) and (c)" in subsection (a) and inserting in lieu thereof "subsection (b)".

(2) Technical amendment.—Paragraph (3) of section 2057(e) of such Code (relating to definition of property passing from a decedent) is amended by striking out "2056(d)" and inserting in lieu thereof "2056(c)".

(b) Gift Tax Deduction.—

(1) In general.—Subsection (a) of section 2523 of such Code (relating to gift to spouse) is amended to read as follows:

"(a) Allowance of Deduction.—Where a donor who is a citizen or resident transfers during the calendar quarter by gift an interest in property to a donee who at the time of the gift is the donor's spouse, there shall be allowed as a deduction in computing taxable gifts for the calendar quarter an amount with respect to such interest equal to its value.".

(2) TECHNICAL AMENDMENT.—Section 2523 of such Code is amended by striking out subsection (f).

(c) EFFECTIVE DATES.—The amendments made by subsection (a) apply to the estates of decedents dying on or after the date of the enactment of this Act. The amendments made by subsection (b) apply to gifts made on or after such date.

SEC. 3. VALUATION OF CERTAIN FARM, ETC., REAL PROPERTY.

(a) DEFINITION OF QUALIFIED REAL PROPERTY.—

(1) IN GENERAL.—Paragraph (1) of section 2032A(b) of the Internal Revenue Code of 1954 (relating to definition of qualified real property) is amended—

(A) by striking out "50 percent" in subparagraph (A) and inserting in lieu thereof "65 percent",

(B) by inserting "and" at the end of subparagraph (A), and

(C) by striking out subparagraphs (B) and (C) and redesignating subparagraph (D) as subparagraph (B).

(2) TECHNICAL AND CONFORMING AMENDMENTS.—

(A) Paragraph (7) of section 2032A(c) of such Code (relating to cessation of qualified use) is amended to read as follows:

"(7) CESSATION OF QUALIFIED USE.—For purposes of paragraph (1)(B), real property shall cease to be used for the qualified use if such property ceases to be used for the qualified use set forth in subparagraph (A) or (B) of subsection (b)(2) under which the property qualified under subsection (b).".

(B) Paragraph (3) of section 2032A(e) of such Code (relating to inclusion of certain real property) is amended by striking out "(C)" and inserting "(A)(i)".

(C) Paragraph (6) of section 2032A(e) of such Code (relating to definition of material participation) is repealed.

(D) Subparagraph (C) of section 2032A(h)(2) of such Code (relating to replacement property) is amended to read as follows:

"(C) Paragraph (7) of subsection (c) shall be applied by not taking into account periods after the involuntary conversion and before the acquisition of the qualified replacement property.".

(b) REPEAL OF $500,000 LIMITATION.—Subsection (a) of section 2032A of such Code (relating to value based on use under which property qualifies) is amended to read as follows:

"(a) VALUE BASED ON USE UNDER WHICH PROPERTY QUALIFIES.—If—

"(1) the decedent was (at the time of his death) a citizen or resident of the United States; and

(2) the executor elects the application of this section and files the agreement referred to in subsection (d)(2),

then, for purposes of this chapter, the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property.".

(c) PROPERTY REQUIRED TO BE HELD ONLY FOR 10 YEARS.—

(1) IN GENERAL.—Section 2032A(c) of such Code (relating to tax treatment of dispositions and failures to use for qualified use) is amended by striking out "15" and inserting "10" in paragraph (1), and

(2) TECHNICAL AMENDMENT.—Paragraph (3) of section 2032A(c) of such Code is repealed.

(d) Section 2032A of such Code is amended by adding at the end thereof the following new subsection:

"(i) SPECIAL RULES FOR EXCHANGES.—

"(1) TREATMENT OF PROPERTY EXCHANGED.—

"(A) IN GENERAL.—If an interest in qualified real property is exchanged—

"(i) no tax shall be imposed by subsection (c) on such exchange if the interest in qualified real property is exchanged solely for an interest in qualified exchange property in a transaction which qualifies under section 1031(a), or

"(ii) if clause (i) does not apply, the amount of the tax imposed by subsection (c) on such exchange shall be the amount determined under subparagraph (B).

"(B) AMOUNT OF TAX WHERE PROPERTY RECEIVED IS NOT SOLELY AN INTEREST IN QUALIFIED EXCHANGE PROPERTY.—The amount determined under this subparagraph with respect to any exchange is the amount of tax which (but for this subsection) would have been imposed on such exchange reduced by an amount which bears the same ratio to such tax as—

"(i) the amount of the interest in qualified exchange property received by the taxpayer bears to "(ii) the sum of the money and the fair market value of all property received in the exchange.

"(2) TREATMENT OF QUALIFIED EXCHANGE PROPERTY.—For purposes of subsection (c)—

"(A) any interest in qualified exchange property shall be treated in the same manner as if it were a portion of the interest in qualified real property which was exchanged, and

"(B) any tax imposed by subsection (c) on the exchange shall be treated as a tax imposed on a partial disposition.

"(3) QUALIFIED EXCHANGE PROPERTY.—For purposes of this subsection, the term 'qualified exchange property' means real property which is to be used for the qualified use set forth in subparagraph (A) or (B) of subsection (b)(2) under which the real property exchanged therefor originally qualified under subsection (a).".

(e) ELECTION REQUIREMENT OF SPECIAL RULES FOR INVOLUNTARY CONVERSIONS REPEALED.—Section 2032A(h) of such Code (relating to special rules for involuntary conversions of qualified real property) is amended—

(1) by striking out "and the qualified heir makes an election under this subsection" in paragraph (1)(A); and

(2) by striking out paragraph (5).

(f) NET SHARE RENTALS.—

(1) IN GENERAL.—Paragraph (7) of section 2032A(e) of such Code (relating to method of valuing farms) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

"(B) VALUE BASED ON NET SHARE RENTAL IN CERTAIN CASES.—

"(i) IN GENERAL.—If there is no comparable land from which the average annual gross rental may be determined but there is comparable land from which the average net share rental may be determined, subparagraph (A)(i) shall be applied by substituting 'average net share rental' for 'average gross cash rental'.

"(ii) NET SHARE RENTAL.—For purposes of this paragraph, the term 'net share rental' means the excess of—

"(I) the value of the produce received by the lessor of the land on which such produce is grown, over

"(II) the cash operating expenses of growing such produce which, under the lease, are paid by the lessor.".

(2) CONFORMING AMENDMENT.—Clause (i) of section 2032A(e)(7)(C) of such Code (as redesignated by subsection (a)) is amended by striking out "may be determined" and inserting in lieu thereof "may be determined and that there is no comparable land from which the average net share rental may be determined".

(g) EFFECTIVE DATE.—The amendments made by this section shall apply to the estates of decedents dying on or after the date of the enactment of this Act.

SEC. 4. ANNUAL GIFT TAX EXCLUSION.

(a) INCREASE IN AMOUNT.—Section 2503(b) of the Internal Revenue Code of 1954 (relating to exclusion from gifts) is amended by striking out "$3,000" and inserting in lieu thereof "$6,000".

(b) ADJUSTMENTS FOR GIFTS MADE WITHIN 3 YEARS OF DEATH.—Paragraph (2) of section 2035(b) of such Code (relating to exceptions to adjustments for gifts made within 3 years of decedent's death) is amended by inserting after "donee" the second place it appears the following: ", or if the decedent was so required with respect to gifts to any donee, that portion of such gifts excludable by reason of section 2503(b) (determined with regard to section 2513(a))".

(c) EFFECTIVE DATES.—The amendment made by subsection (a) shall apply to gifts made after December 31, 1979. The amendment made by subsection (b) shall apply to the estates of decedents dying after December 31, 1976.

II

96TH CONGRESS
1ST SESSION

S. 2136

To amend the Internal Revenue Code of 1954 to reduce the rate of tax on corporations.

IN THE SENATE OF THE UNITED STATES

DECEMBER 14 (legislative day, NOVEMBER 29), 1979

Mr. NELSON (for himself, Mr. BAUCUS, Mr. BOREN, Mr. MATSUNAGA, Mr. STEWART, Mr. PELL, Mr. WEICKER, and Mr. DURKIN) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to reduce the rate of tax on corporations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Small Business Tax Reduction Act of 1979".

SEC. 2. Subsection (b) of section 11 of the Internal Revenue Code of 1954 (relating to amount of tax on corporations) is amended—

(1) by striking out "17 percent" in paragraph (1) and inserting in lieu thereof "15 percent";

(2) by striking out "$75,000;" in paragraph (3) and inserting in lieu thereof "$100,000;",

(3) by striking out "$75,000 but does not exceed $100,000" in paragraph (4) and inserting in lieu thereof "$100,000 but does not exceed $150,000", and

(4) by striking out "$100,000," in paragraph (5) and inserting in lieu thereof "$150,000,".

SEC. 3. The amendments made by the first section of this Act shall apply with respect to taxable years beginning after September 30, 1979.

II

96TH CONGRESS
1ST SESSION

S. 2168

To amend the Internal Revenue Code of 1954 to permit an electing small business corporation to have thirty-five shareholders and to issue certain additional stock.

IN THE SENATE OF THE UNITED STATES

DECEMBER 20 (legislative day, DECEMBER 15), 1979

Mr. NELSON (for himself, Mr. BAUCUS, Mr. BOREN, Mr. HUDDLESTON, Mr. MATSUNAGA, and Mr. STEWART) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to permit an electing small business corporation to have thirty-five shareholders and to issue certain additional stock.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Subchapter S Capital Formation Act of 1979".

SEC. 2. SECTION 1371 AMENDMENTS.

Section 1371 of the Internal Revenue Code of 1954 (relating to small business corporation definitions) is amended—

(1) by striking out "15 shareholders" in paragraph (1) of subsection (a) and inserting in lieu thereof "100 shareholders".

(2) by inserting "except as provided in subsection (f)," before "have" in paragraph (4) of subsection (a), and

(3) by adding at the end thereof the following new subsection:

"(f) ADDITIONAL CLASS OF STOCK MAY BE ISSUED.—A corporation shall not be treated, for the purpose of subsection (a)(4), as having more than one class of stock if the second, or any other additional, class of stock is issued in accordance with regulations prescribed by the Secretary under which the issuance of such stock will not have any effect upon the allocation of income among the shareholders of the corporation.".

SEC. 3. EFFECTIVE DATE.

The amendment made by section 2 of this Act shall apply with respect to taxable years beginning with or ~~in cal-~~endar years beginning after the date of enactment of this Act.

II

96TH CONGRESS
1ST SESSION

S. 2171

To amend the Internal Revenue Code of 1954 to provide that an early W-2 must be furnished to a terminated employee before January 31 only upon the receipt of a written request, and for other purposes.

IN THE SENATE OF THE UNITED STATES

DECEMBER 20 (legislative day, DECEMBER 15), 1979

Mr. NELSON introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide that an early W-2 must be furnished to a terminated employee before January 31 only upon the receipt of a written request, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (a) of section 6051 of the Internal Revenue Code of 1954 (relating to receipts for employees) is amended—

(1) by striking out "on the day on which the last payment of remuneration is made" and inserting in lieu

thereof "within 30 days after receipt of a written request from the employee if earlier"; and

(2) by adding at the end thereof the following new sentence: "In the case of an employee whose employment is terminated before the close of a calendar year, the employer shall furnish the employee, on the day on which the last payment is made, a general written notice stating that (A) the employee may request in writing that such information be provided within 30 days of such request if earlier than January 31, (B) an amount of Federal taxes has been withheld, and (C) if the employee is entitled to a refund, he must file a Federal income tax return based on information which, unless a request is made by the employee, will be sent to the employee at his last known address before January 31 of the next calender year.".

SEC. 2. The amendments made by this Act shall take effect 30 days after the date of enactment of this Act.

II

96TH CONGRESS
2D SESSION

S. 2220

To amend the Internal Revenue Code of 1954 to provide for the exclusion from the gross estate of a decedent of a portion of the value of certain interests in a farm or trade or business if the spouse or children of the decedent materially participate in such farm or trade or business.

IN THE SENATE OF THE UNITED STATES

JANUARY 24 (legislative day, JANUARY 3), 1980

Mr. NELSON (for himself, Mr. BAUCUS, Mr. HEINZ, and Mr. STEWART) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide for the exclusion from the gross estate of a decedent of a portion of the value of certain interests in a farm or trade or business if the spouse or children of the decedent materially participate in such farm or trade or business.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) this Act may be cited as the "Family Business Protection Act of 1980".

SEC. 2. Part III of subchapter A of chapter II of the Internal Revenue Code of 1954 (relating to gross estates) is amended by adding after section 2040 the following new section:

"SEC. 2040A. FAMILY BUSINESS INTERESTS.

"(a) GENERAL RULE.—The value included in the gross estate with respect to such interest by reasons of this section shall be—

"(1) the value of such interest, reduced by

"(2) the section 2040A value of such interest.

"(b) LIMITATIONS.—

"(1) 50 PERCENT MINIMUM EXCLUSION.—In no event shall the application of this section and section 2040(c) result in the inclusion of the decedent's gross estate of less than 50 percent of the value of such interest.

"(2) AGGREGATE REDUCTION.—The aggregate decrease in the value of the decedent's gross estate resulting from the application of this section and section 2040(c) shall not exceed $500,000.

"(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) SECTION 2040A PROPERTY DEFINED.—The term 'section 2040A property' means any interest in any real or tangible personal property which is devoted to use as a farm or used for farming purposes (within the meaning of paragraphs (4) and (5) of section 2032A(e)) or is used in any other trade or business and is passed to the spouse or any child of the decedent (or both).

"(2) SECTION 2040A VALUE.—The term 'section 2040A value' means—

"(A) the value of the interest (determined without regard to this section), reduced by

"(B) 5 percent for each taxable year in which the spouse materially participated in the operation of the farm or other trades or business and 5 percent for each taxable year in which any child of the decedent materially participated in the farm or other trade or business.

For purposes of subparagraph (B) and subject to the provisions of subsection (d), any individual who has materially participated in the farm or other trade or business during the taxable year in which the date of death of the decedent occurs shall be treated as having materially participated in such farm or trade or business during the 5 succeeding taxable years.

"(3) MATERIAL PARTICIPATION.—The term 'material participation' shall be determined in a manner similar to the manner used for purposes of paragraph

(1) of section 1402(a) (relating to net-earnings from self-employment).

"(4) CHILD.—The term 'child' includes a step-child and adopted child of the decedent.

"(d) TAX TREATMENT OF DISPOSITIONS AND FAILURE TO USE.—

"(1) IMPOSITION OF ADDITIONAL TAX.—If, within 5 years after the decedent's death, the spouse or any child of the decedent—

"(A) disposes of any interest in section 2040A property (other than by a disposition to the spouse or any child), or

"(B) ceases to use the section 2040A property as a farm or for farming purposes or in a trade or business.

"(2) AMOUNT OF ADDITIONAL TAX.—The amount of the additional tax imposed by paragraph (1) shall be an amount equal to the excess of—

"(A) the amount of the tax which would have been imposed by section 2001 determined without regard to this section, over

"(B) the amount determined under section 2001 with regard to this section.".

(b) The table of sections for part III of subchapter A of chapter II of such Code is amended by inserting after the item relating to section 2040 the following new item:

"Sec. 2040A. Family business interests.".

SEC. 3. The amendments made by this Act shall apply to the estate of decedents dying after December 31, 1979.

II

96TH CONGRESS
2D SESSION

S. 2239

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of incentive stock options.

IN THE SENATE OF THE UNITED STATES

JANUARY 30 (legislative day, JANUARY 3), 1980

Mr. PACKWOOD (for himself, Mr. NELSON, and Mr. CRANSTON) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 with respect to the income tax treatment of incentive stock options.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part II of subchapter D of chapter 1 of the Internal Revenue Code of 1954 (relating to certain stock options) is amended by adding after section 422 the following new section:

"SEC. 422A. INCENTIVE STOCK OPTIONS.

"(a) IN GENERAL.—Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option if—

"(1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 1 year after the transfer of such share to him, and

"(2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

"(b) INCENTIVE STOCK OPTION.—For purposes of this part, the term 'incentive stock option' means an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if—

"(1) the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options, and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

"(2) such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

"(3) such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;

"(4) the option price is not less than the fair market value of the stock at the time such option is granted;

"(5) such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

"(6) such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

Paragraph (6) shall not apply if at the time such option is granted the option price is at least 110 percent of the fair market value of the stock subject to the option and such option by its terms is not exercisable after the expiration of 5 years from the date such option is granted. For purposes of paragraph (6), the provisions of section 425(d) shall apply in determining the stock ownership of an individual.

"(c) SPECIAL RULES.—

"(1) EXERCISE OF OPTION WHEN PRICE IS LESS THAN VALUE OF STOCK.—If a share of stock is transferred pursuant to the exercise by an individual of an option which would fail to qualify as an incentive stock option under subsection (b) because there was a failure in an attempt, made in good faith, to meet the requirement of subsection (b)(4), the requirement of subsection (b)(4) shall be considered to have been met.

"(2) VARIABLE PRICE OPTION.—

"(A) IN GENERAL.—For purposes of subsection (b)(4), the option price of a variable price option shall be computed as if the option had been exercised when granted.

"(B) DEFINITION.—For purposes of this paragraph, the term 'variable price option' means an option under which the purchase price of the stock is fixed or determinable under a formula in which the only variable is the fair market value of the stock at any time during a period of 1 year which includes the time the option is exercised;

except that such term does not include any such option in which such formula provides for determining such price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised.

"(3) CERTAIN DISQUALIFYING DISPOSITIONS WHERE AMOUNT REALIZED IS LESS THAN VALUE AT EXERCISE.—If—

"(A) an individual who has acquired a share of stock by the exercise of an incentive stock option makes a disposition of such share within the 2-year period described in subsection (a)(1), and

"(B) such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to such individual,

then the amount which is includible in the gross income of such individual, and the amount which is deductible from the income of his employer corporation, as compensation attributable to the exercise of such option shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share.

"(4) CERTAIN TRANSFERS BY INSOLVENT INDIVIDUALS.—If an insolvent individual holds a share of stock acquired pursuant to his exercise of an incentive stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding, neither such transfer, nor any other transfer of such share for the benefit of his creditors in such proceeding, shall constitute a disposition of such share for purposes of subsection (a)(1).".

(b)(1) Section 421(a) of such Code (relating to general rules in the case of stock options) is amended by inserting "422A(a)," after "422(a),".

(2) Section 425(d) of such Code (relating to attribution of stock ownership) is amended by inserting "422A(b)(6)," after "422(b)(7),".

(3) Section 425(g) of such Code (relating to special rules) is amended by inserting "422A(a)(2)," after "422(a)(2),".

(4) Section 425(h)(3)(B) of such Code (relating to definition of modification) is amended by inserting "422A(b)(5)," after "422(b)(6),".

(5) Section 6039 of such Code (relating to information required in connection with certain options) is amended—

(A) by inserting ", an incentive stock option," after "qualified stock option" in subsection (a)(1),

(B) by inserting "incentive stock option," after "qualified stock option," in the second sentence of subsection (a), and

(C) by adding at the end of subsection (d) the following new paragraph:

"(4) The term 'incentive stock option', see section 422A(b).".

(6) The table of sections for part II of subchapter D of chapter 1 of such Code is amended by inserting after the item relating to section 422 the following new item:

"422A. Incentive stock options.".

SEC. 2. The amendments made by this Act shall apply with respect to options granted after the date of enactment.

Senator BYRD. The hour of 10 having arrived, the committee will come to order.

Throughout the 20th century, a fundamental purpose of the estate tax law has been to prevent massive concentration of wealth and power in the hands of a few.

I support this objective.

Enormous wealth in the hands of a few threatens the openness and opportunity which is the heart of the American concept of justice.

While the fundamental philosophy behind the estate tax remains sound, the economic realities of the past several years necessitate a review of the current law.

Inflation, fueled by excessive Government deficit spending, has caused a rapid increase in the value of assets subject to the estate tax, with no increase in real value.

Family farms and small businesses are finding it harder and harder to continue in operation from generation to generation because of lack of liquid capital to pay estate taxes.

Investment capital needed for future economic growth is now scarce and becoming scarcer.

Each of these factors must be considered in structuring an estate tax which meets the underlying policy goals of the tax without eradicating savings and investment accumulated over a lifetime or incentives for private capital formation.

In 1976, Congress made major revisions in the estate tax. These revisions, on the whole, were a step in the right direction. The exemption from estate taxes was raised; the gift and estate taxes were unified; the top marginal estate tax rate was reduced; a generation-skipping tax was imposed; and special use rules for valuing farms were developed.

The 1976 revisions did not, however, solve all of the problems associated with the estate tax and created new problems.

The carryover basis provisions were included in 1976. Fortunately, Congress has acted to repeal these provisions which would have been disastrous for farms, small businesses, and the average American family.

The revisions in 1976 have also created greater technical complexity in the tax law.

The wage earner sees the value of his estate, with assets such as a home, driven up by inflation. The estate tax is becoming a tax upon inflation. Today, the inflation rate is 18 percent. Assuming inflation of only one-half the current rate—9 percent—in the future, the estate tax could indeed be heavy.

For example, at a 9-percent inflation rate for the next 20 years, a house worth $70,000 today would be worth $421,000 with no change in real value. An estate tax levied upon such an asset could wreak havoc upon many families.

Farmers are finding the special use valuation rules difficult to use and in need of revision.

The current estate tax exemption is small when compared with capital formation needs of small businesses.

Revision of the estate tax laws to ease the tax burden on family-owned businesses and encourage the continuity of family ownership was a top recommendation of the delegates to the recently completed White House Conference on Small Business.

The hearings today, centering around the estate tax law and its effect upon families and small businesses, are the first in a series which will examine the tax recommendations of the White House Conference.

While a number of bills amending various estate and gift tax provisions have been introduced in the Senate, S. 1984, introduced by Senator Wallop and others, and S. 1825 and S. 2220, introduced by Senator Nelson and others, have been set for consideration in these hearings. Also, the subcommittee looks forward to hearing general recommendations and suggestions about estate tax revisions which may be needed to meet the problems posed by the estate tax for families and family businesses.

I might say at this point, the distinguished Senator from Wisconsin, Mr. Gaylord Nelson, is very much interested in this entire field. Several of the bills being considered today were introduced by Senator Nelson. He is chairman of an ad hoc task force on small business appointed by the Senate majority leader.

The chairman of this subcommittee happens to be a member of that task force also. Senator Wallop is very much interested in this matter and has introduced legislation, and his bill will be considered today.

I might say, for the record, that the Treasury Department was invited to testify at this hearing but called Friday afternoon to say that scheduling difficulties made it impossible for them to be present this morning.

Before calling on the first panel, I would like to call on the distinguished senior Senator from Oregon, Mr. Packwood, who is the ranking Republican member of the subcommittee.

Senator Packwood?

Senator Packwood. I have no statement, Mr. Chairman.

Senator Byrd. Senator Wallop?

Senator Wallop. Mr. Chairman, I have a statement but I would just as soon get on with the hearing and just insert the statement in the record.

Senator Byrd. Very well. Without objection, your statement will be inserted in full in the record.

[The statement of Senator Wallop follows:]

PREPARED STATEMENT OF SENATOR MALCOLM WALLOP

I want to thank the Chairman of the Taxation and Debt Management Subcommittee for holding these hearings on S. 1984 and the other tax proposals recommended by the White House Conference on Small Busniness. It is gratifying to see that Chairman Byrd continues to take a leadership role on behalf of family-owned farms and businesses.

Senator Byrd, I have been impressed by the amount of interest created by these hearings, indicated by the number of people who have requested to testify on the legislation before this Subcommittee today. The constraints of time have made it impossible for some of these groups to testify at today's hearing, but I hope that we will have more time during future hearings to listen to more testimony on these bills.

The bills before the Subcommittee today offer some alternatives to existing tax provisions in an attempt to recognize the changing needs of farmers and family-owned small businesses. I am delighted that Senator Nelson is lending this Subcommittee the experience and insights he has gained as Chairman of the Small Business Committee. We share the same goals and concerns in this area, and I look forward to working with him on changes in the tax laws essential to the growth of small business.

In the past few weeks Congress has suddenly become aware of the array of economic problems facing the nation. We have new converts to supply side economics and scores of born again budget balancers. As we struggle for answers to inflation, high interest rates, and the broad fiscal aspects of our economic problems, it is essential that Congress also pay close attention to the effects these conditions have on family-owned farms and small businesses. If we adopt new policies or fail to examine how existing laws result in the destruction of small business, then all of our attention to the general economy will be misguided. Inflation, high interest rates and taxes create unique problems for small business which I look forward to examining through these hearings.

One of the most prominent concerns in the minds of farmers, ranchers, and small businessmen in Wyoming is the interaction between inflation and the estate tax laws. The escalating prices of farmland make it extremely difficult for the average farm family to meet the rising burden of estate taxes. Too often, farm families face the difficult choice between extended periods of indebtedness and the sale of the family farm. The immediate result is that we see increasing amounts of agricultural land going into subdivisions or into the hand of large corporations or foreign investors. What we have at stake is not just the transfer of farm ownership from one individual to another, but a change in the character of American agriculture. My concern is that unless we remove the complexities and needless burdens created by the estate tax laws, we may preside over the destruction of the family farm.

One of the most important changes called for in this area is the unlimited marital deduction called for in S. 1984. Providing an unlimited marital deduction recognizes that most married couples regard themselves as a single economic unit. Upon the death of the husband, many wives of farmers and small businessmen discover that their work on the farm or business over the years were inconsequential in the eyes of the I.R.S. An economic unit that was shared over a lifetime is suddently recognized for estate tax purposes as being "his" and estate taxes must be paid on the estate.

I simply cannot accept this premise. When I speak of the contributions made by farm and ranch wives, I am not making a historical reference to their contribution in setting this country. There is a need to change this provision in the estate tax laws so that they reflect the role played by wives as equal partners in running a farm or small business today. The contributions of a wife as bookkeeper, business manager, financial consultant, as well as homemaker are essential to the acculumlation of assets and merits recognition in the estate tax laws. Such a change in the estate tax laws would not only ease the estate tax burden on family-owned farms and small businesses, it would remove an outdated inequity in the laws as well.

Senator BYRD. The panel which the committee will now hear will be a panel of four: Mr. Frank S. Berall, cochairman, Estate and Gift Tax Committee, American College of Probate Counsel; Mr. Dave L. Cornfeld, vice chairman for publications of the American Bar Association's Tax Section; Mr. J. Thomas Eubank, last retiring chairman of the American Bar Association's Real Property, Probate and Trust Section; Mr. Edward C. Halbach, Jr., chairman-elect of the American Bar Association Real Property Probate and Trust Section.

Mr. Eubank, suppose we call on you first.

STATEMENT OF J. THOMAS EUBANK, LAST RETIRING CHAIRMAN, REAL PROPERTY, PROBATE AND TRUST LAW SECTION, AMERICAN BAR ASSOCIATION

Mr. EUBANK. Thank you, Senator Byrd.

Because of jobs that I have and have had in various bar associations, I have tried to stay in touch with lawyers from coast to coast in this country about the problems that their clients, who are the taxpayers of this country, are having in connection with the practical aspects of estate and gift taxation and related income taxation.

A central theme that I have heard, when I talked to these lawyers recently, is the increasing difficulty that the taxpayers are having in paying the estate tax, not only with regard to farms and other family businesses, but with regard to virtually all estates.

Another central theme I have heard involves the complexity of the laws and the difficulties that the taxpayers are facing in complying with those laws, in spite of full good faith efforts to do so.

With those thoughts in mind, I would like to emphasize this morning the subject of rates, the estate and gift tax rates.

First, I would like to approach the subject with inflation in mind. Now, I am sure that every Member of Congress is acutely aware of the income tax increases that result automatically from inflation in combination with progressive rates. It may be that some Members of Congress have not focused on the estate tax rates in this regard, for exactly the same thing is happening there.

In order to get into the subject, I have started with an estate of $250,000 at the beginning of 1977, a date I selected because that was when the current rate first went into effect.

Then I assumed a 10-percent inflation rate per year for the next so many years, say out to 7 years, the beginning of 1984, and I assumed that there were no real changes in values of the properties, only changes commensurate with the inflation rate.

That means that 7 years afterwards—that is, at the beginning of 1984—a $250,000 estate will be a $500,000 estate, and it will mean that there has been a tax increase on that estate from $23,800 in 1977 all the way up to $108,800 in 1984.

Senator BYRD. Excuse me. May I ask you this question to get it clear?

Are you saying that because of inflation, the value of the estate will double in 7 years?

Mr. EUBANK. Yes. At a 10-percent annual rate for 7 years, the net result, if the values move right along with inflation, is a doubling in value of the properties; and we will also be assuming a 50-percent decline in the value of the dollar during the same period, that being the mathematical result.

Now, that dramatic increase from $23,800 to $108,800 should be adjusted, however, because the taxes payable in 1984 would be payable with 50 cent dollars. Therefore, in order to use constant dollars, I have, in appendix A to my statement, cut in half the taxes.

For example, I cut that $108,800 tax figure down to $54,400. In other words, in constant dollars, inflation coupled with progressive rates would have increased the tax on that relatively modest estate from $23,800 to $54,400. That, of course, is an alarming increase that I doubt that Congress had in mind when enacting the current rates.

In appendix A to my prepared statement, I have shown calculations for estates of other sizes all the way up to $2.5 million.

An interesting pattern develops. With constant 1977 dollars, the tax increase for a $2.5 million estate is 28 percent; and this percentage increase drops as the estate size is lowered until it reaches 22 percent for estates in the $1.25 million and $1.5 million range.

But, as you drop lower in estate size, the increase starts going up dramatically. In the case of an 1977 estate of $500,000, the increase is 37 percent in constant dollars.

In the case of a $250,000 estate, which is in the lower range of taxable estates, the percentage increase is an alarming 129 percent. In other words, the tax on that $250,000 estate will have increased under these assumptions from 10 percent in 1977 to 22 percent of the estate in 1984.

I think that appendix A, with the information there set forth, leads to a number of important conclusions.

First, this combination of inflation and progressive rates calls for adjustments downward throughout the schedule.

Second, it calls for a substantial increase in the unified credit, which is the device that now exempts estates from taxation below $175,000.

Third, I note that the need for adjustment in the rates is the greatest in the case of estates at the lower end, especially in the case of estates between $175,000 and $500,000.

Fourth, I note that inflation is having the effect of once again taxing the smaller estates that Congress exempted and intended to exempt in 1976 from the estate tax process.

Under these assumptions, in just a few years from now, an estate of $88,000 in 1977 will have doubled in size and will have entered the taxable category.

Next I would like to approach rates with special use valuations in mind. You recall that in 1976, Congress passed a new section on special use valuations for farms and other family businesses based primarily on real estate. How is this section working?

Overall, it is working spasmodically and with great unevenness. There are severe administrative difficulties, one of which involves the crop-sharing problem.

The law, as written, provides clearly that the discount in value occurs for farms in those areas where a cash rental is the prevailing custom; but in those areas where the prevailing custom is a rental based on crop-sharing, the intended reduction in value is not happening.

In the case of those farms having a determinable cash value rental, the discounts are, I understand, as much as 70 percent below fair market value. In the case of those farms in other areas where the custom is based on crop-sharing, the indication is that under the five-factor formula, that they have to use there, the rate reduction is either zero or perhaps as much as 20 percent.

There are also the family businesses that come within section 2032A and that must use the five-factor formula; they are getting a relatively modest decrease in value compared to the other situations.

The result is that there is a substantial unevenness under the special use value section. Many of the considerations that led Congress in 1976 to enact special use valuation, it seems to me, are applicable to many other estates. There are the family businesses not based on real estate. Many of the considerations that led to the enactment of section 2032A apply today to those estates.

Also there are the estates that may be the great overlooked estates, the ones consisting primarily of marketable securities.

Why should an estate with a farm or other family business be preferred in the tax laws over an estate with neither but with marketable securities in the business corporations of this Nation?

The importance of holdings in these securities must not be overlooked if we are to have a private sector economy adequate for the needs and growth of this country.

Yes, farms and other family businesses have special problems and special needs that do not exist fully in the case of an estate with marketable securities; but the estates with marketable securities have a lot of those problems and many of the rationales behind section 2032A would lead also to similar considerations and reliefs in other estates—even including estates consisting primarily of marketable securities.

For example, it is desirable to encourage the continued ownership of marketable securities in the private sector, just as it is desirable to encourage the continued ownership of the family farm.

Taxing these marketable securities transfers a portion to the public sector, where that portion is spent and dispersed in a manner which does not result in a return of all of that portion to private sector capital. This reduction in private sector capital can be made up only by productive increases in private sector capital or by infusions of after-tax income into private sector capital; and that, of course, is not occurring nearly as much as this Nation needs today.

There is a widely recognized shortage of private sector capital which has led to a decline of our Nation's productivity.

There is tremendous pressure to increase the special use value concept. These pressures signal to me that the estate taxes are too high, not only for these people, but for other taxpayers as well. It is for that reason that I get into the subject of rate adjustments.

Finally, and very briefly, I want to echo Senator Byrd's words a minute ago about the fundamental purpose of the estate tax. In my judgment, the fundamental purpose is to tax the very wealthy very heavily, to limit undue concentrations of wealth and power in a few, to break up those concentrations and to enhance equality of opportunity.

With those thoughts in mind I now ask whether it makes any sense to tax an estate of $500,000? Is that the size estate that we are trying to break up?

What about a $1 million estate or even a $2 million estate? Are these concentrations of wealth really significant?

Are they ones that we want to break up? Are not these holdings the very backbone of the private sector economy that we wish to preserve because they are large enough to include significant investment capital needed in the private sector economy but not large enough to create undue social problems?

With these thoughts in mind, I have set forth in my prepared remarks some basic proposals. I have suggested that the unified credit be increased substantially.

Inflation alone would cause an increase to an exemption equivalent of $350,000; but I believe that when the fundamental purposes are considered, the unified credit ought to be set so that estates of $500,000 and under would be exempted entirely from the complicated estate tax process.

As to rates, I have suggested that above $500,000 they start somewhat lower than they are right now, that they start somewhere around 25 percent and that they increase very moderately to a substantial amount—say $2.5 million—where they would have reached approximately 35 percent.

Further, I would suggest that after $2.5 million, the rates start increasing very sharply until they get to the top amount and the top rate, which are, as you know, now $5 million and 70 percent.

Once the new rates have been fixed and are in mind and once the unified credit has been reduced, then I would suggest that a very close look be given to the special problems of farmers and other family business owners to see how much their problems have been solved by a general rate reduction and a general unified credit increase.

In a preliminary effort to do that, I have included appendix B that makes a stab in that direction. It shows that these rate reductions would produce very substantial relief but probably not as much as may be needed.

Once the new rate system and the new credit are fixed, then we ought to look at the special problems and consider not only the special use valuation section, but all of the other sections that constitute a part of the overall relief for farmers and other family business owners.

To tick them off, those would include: the estate tax deferral as a matter of right sections; the stock redemption for death tax section; the interest rate on deferred tax sections; and others.

Section 2032A, the special use valuation section, is in need of revision and rethinking, if for no other reason, in order to smooth it out and to make its effect more even.

As a part of this proposal, I am suggesting that sections 6166 and 6166A be merged. You will recall those are the sections dealing with estate tax deferral as a matter of right.

One has a pay-out provision that is easier for taxpayers, but qualification is very difficult under that section. The other has a relatively easy qualification provision, but a more difficult pay-out provision.

My suggestion is that consideration be given to merging those two sections, incorporating the more liberal features of each into the merged section. Hand in glove with the deferral is the stock redemption section for death taxes. That is section 303.

This section got a lot of attention in 1976. The net result was that the 35-percent qualifying test got moved up to a 50-percent test. It was first moved up to a 65-percent test by the House, but the conference committee moved it back to a 50-percent test.

At the same time, they left the 35-percent test in effect for one of the estate tax deferral sections. I never have been able to understand that; and as part of my proposal today, I am asking Congress to consider going back to the pre-1976 version of section 303, except that the test ought to be 35 percent of the adjusted gross estate, rather than 35 percent of the gross estate.

I would like to suggest also that the subcommittee and the Congress reconsider the subject of interest rates on deferred taxes, especially in light of recent developments. We all know that special provisions were made in very limited situations for a 4-percent rate where the estate tax was deferred under section 6166. That 4-percent rate is in effect for amounts up to a little over $300,000 in deferred tax.

Congress, when it fixed this, had in mind that the next jump would be up to the then-current rate of 7 percent. That rate now, of course, is 12 percent and that is an enormous jump that many businesses cannot make.

Thank you very much, Senator.

Senator BYRD. Thank you, Mr. Eubank.

Mr. Berall?

STATEMENT OF FRANK S. BERALL, COCHAIRMAN, ESTATE AND GIFT TAX COMMITTEE, AMERICAN COLLEGE OF PROBATE COUNSEL

Mr. BERALL. Thank you, Senator Byrd. I am Frank Berall from Hartford, Conn.

There are three administrative matters that I would like to take up, with your permission, before beginning my testimony.

First of all, I want to stress that I am here in my individual capacity as a private attorney and my views do not necessarily represent those of any group with which I am associated.

Second, I noticed in preparing my testimony last night that there were several typographical errors—mag card mistakes—on some of the pages. I would like to replace these pages before this testimony is printed, if that is possible, this week.

Senator BYRD. Yes.

Mr. BERALL. Third, if time permits, my remarks do run a little longer than the allowable 20 minutes. I do not want to cut into anybody else's time, but if it is possible to run a little over, I would like permission to do so.

Senator BYRD. I think we can do that.

Mr. BERALL. Thank you, Senator.

I want to begin by stressing what Mr. Eubank has already pointed out and what you have pointed out, Senator Byrd, that the basic policy of Congress in enacting the estate and gift tax laws is to prevent the concentration of large amounts of wealth and power. Actually, in the opinion of most of us who have studied the history of the estate and gift tax laws has been really incidental and relatively unimportant to these and the new generation-skipping transfer taxes.

Just as a matter of figures, the Federal estate and gift taxes and the generation-skipping taxes are estimated to produce approximately $5 billion in current fiscal years and it is my understanding that the entire Federal tax take is estimated at $616 billion. This means that the transfer taxes are really 0.81 percent of total Federal revenues.

I think the conclusion to be drawn from the relative insignificance of the estate and gift taxes to revenue production is that the changes that I believe are necessary, which are generally in accordance with the changes believed to be necessary by my other colleagues on this panel, although they may lose some revenue, will so improve the system by making it a less onerous one with respect to the family farm, the small business, capital formation, the need for the surviving spouse to be fully protected with income during his or her life, et cetera, that these changes are worth giving up a very small fraction of the total Federal revenues in order to achieve them.

Furthermore, what I am also going to suggest is that the kind of restructuring needed in the Federal estate and gift taxes would be in the direction of making it easier to comply with the laws, both on the part of the Internal Revenue Service and their ability to administer these laws, and on the part of the taxpayer; namely, the estate and its personal representatives. This means, gentlemen, that simplification of the tax laws should be one goal of tax policy.

With that overall view of my philosophy of what we should do in restructuring these laws, I want to echo Tom Eubank in his stressing the importance of major rate reduction in the lower brackets. We are talking about estate taxes on estates under $2.5 million, an increase in the unified credit, which I think is well in order in the light of inflation, plus something which lack of time prevented Mr. Eubank from mentioning, and that is the need to make an inflation adjustment to the $3,000 gift tax exclusion.

Let me briefly mention some history on that point. The gift tax exclusion originally was $5,000 when the first permanent gift tax was enacted in 1932. It was reduced to $3,000 in 1942 and it remains at $3,000.

Gentlemen, I respectfully suggest that the Congress consider increasing the gift tax exclusion to as much as $10,000, to adjust it for the inflation since 1942.

The main thrust of my testimony this morning is going to be in the area of the marital deduction, with particular attention to the proposals made by Senator Wallop with respect to the unlimited marital deduction, the expansion of the marital deduction on a quantitative basis which Senator Wallop has in his bill, and an additional concept which must accompany any quantitative expansion of the marital deduction, which I call the qualitative expansion of the marital deduction.

Let me lay a foundation for my recommendations by describing briefly the history of the marital deduction and its status today.

First of all, as I think all of you gentlemen are aware, there are two kinds of legal systems with respect to property in the United States today. One of them is the common law system derived from the law of England. This exists in most States. The other is the community property system which exists in eight States in the Southwest and the West as well as the Commonwealth of Puerto Rico.

It was the conflicting tax results between these two systems of law which, in 1948, induced the Congress to pass the marital deduction and attempt to equalize the treatment of Federal estate and gift taxes with respect to property passing from decedents in community property States with that from decedents in common law States.

Senator BYRD. What year was that?

Mr. BERALL. It was in the Revenue Act of 1948, which also brought in the joint return filing system for income tax purposes.

Under community property concepts, half of the property acquired during a marriage—other than by gift or inheritance—is attributed to each spouse. An attempt was made in the 1948 Revenue Act to have a 50–50 split of other property. But it was not entirely successful because in a common law State if the spouse with the lesser amount of property died first, the marital deduction granted for up to 50 percent of the adjusted gross estate—which was the original marital deduction in the 1948 Revenue Act—would be obviously of very little use. Thus, the wrong order of death defeats the attempt to equalize the tax through the marital deduction, unless there had been substantial transfers during life.

The Revenue Act of 1948 provided for this as well and it allowed a marital deduction for transfers by gift. Half of the gifts between spouses were allowed as a marital deduction.

Then, in 1976, there was a major restructuring of the marital deduction concept. Briefly, this gave the estate tax marital deduction to the greater of one-half of the adjusted gross estate or $250,000. In addition, it provided for a gift tax marital deduction for the first $100,000 of gifts and 50 percent of all interspousal gifts over $200,000.

The problem with the marital deduction as it currently exists, is that the surviving spouse, in order to receive a qualifying marital deduction interest which would result in the reduced estate tax at the death of the first spouse to die, must receive an interest equivalent to absolute ownership. In other words, the interest must be taxable in his or her estate at his or her subsequent death.

That in itself makes sense, and I would not propose that it be changed. What I am going to suggest is that we try to simplify the whole concept of the marital deduction and eliminate a monstrous rule, known as the terminable interest rule, which, in essence, says that for a surviving spouse to have the equivalent of absolute ownership, he or she must have an interest which does not terminate either before or at death and then pass to somebody else.

I do not want to go into the complexity of this terminable interest rule. I just want to say that, over the years since this was added in 1948 there has been a tremendous amount of litigation over it. Knowledgeable attorneys are able to draw marital deduction provisions without running afoul of the terminable interest rule, but many lawyers in general practice who occasionally do some estate planning violate this rule, which is administered very technically by the Internal Revenue Service and is really unnecessary to protect the revenue or implement the policy of the marital deduction.

The other defects, as I see them, in the present marital deduction are that gifts are made between spouses who are frequently unaware that they must be reported for gift tax purposes. There is a requirement in the law that all transfers in excess of $3,000 must be reported on a gift tax return. It is against human nature to expect husbands and wives to comply.

Those of us who practice law privately are constantly advising our clients that they have to file back gift tax returns to straighten out the mess of transfers, either outright or into joint ownership which have been made over the years.

So the gift tax law creates noncompliance problems because it runs counter to the concept that most married people have that the property acquired by them during their marriage is "our property." Perhaps a great many people in this country, even those living in the common law States, have what is really a community property concept of marital property. But the Congress cannot change the property laws in the common law States, nor do I think that it should change them, even if it could. What it can do is conform the taxation of property passing between spouses to generally accepted practices in the country so that noncompliance can be reduced and the tax laws simplified. There is a normal tendency on the part of most married couples, at least in a first marriage, to want to give everything to each other. As attorneys we have to resist this for tax reasons.

Even if the proposals which I am suggesting are adopted by the Congress, in many large estates it will still be necessary to lean against this tendency, for practical reasons, so as not to give everything to a first spouse and have little left over should something go wrong with the marriage or for the children. But I have some suggestions that will deal with that.

Another problem with the existing laws with respect to the marital deduction is that they do not allow for the very common situation of the second and subsequent marriage where there already are children by the first marriage. The client who wants to dispose of his property in a will or trust which he is executing in contemplation of a second marriage is concerned because he really wants to protect the children of his first marriage while, at the same time, making sure that his second wife has sufficient property to take care of her for her entire life.

What he really would like to do in many instances is to give his second wife a life interest in the property, let her have all the income for life, but let the remainder pass to the children of his first marriage at her death. But this type of interest does not qualify for the marital deduction.

I propose that the law be changed to permit the marital deduction with the revenue lost recovered at the death of the surviving spouse. After all, even under present law, the marital deduction is basically a tax postponement device. Therefore, if the property is not taxed at the death of the first spouse, it should be taxed at the death of the second one.

Finally, there are a number of technical complexities with respect to the terminable interest rules and the rules that require tracing of property, particularly in joint tenancies, which I think can be eliminated with a resulting simplification of the administration of the tax laws and without any great loss of revenue.

In summary, the problems of the existing rules are of great complexity, low public awareness of how they operate, widespread misinformation, widespread noncompliance, difficulty in administration and enforcement, probably relatively low revenue production and inequities between people who live in the community property and common law States. The past measures take to correct these have not really worked out well.

What is the solution? Conform the laws to what most people believe it to be. What a large majority of people do is arrange their ownership of marital property in the way that suits the particular purpose of their marriage, while acting as though there were no Federal gift taxes. My point is that there no longer should be any gift tax return filing requirements for gifts between spouses.

How do you deal with this? You provide that any transfer between spouses while they are alive will be ignored for gift and estate tax purposes. This means that you should permit tax-free gifts between spouses in either direction. Then you do not have to worry about recordkeeping. You can get rid of a lot of joint property problems, perhaps all of them between spouses, and then you go one step further. You give a tax-free unlimited marital deduction against the Federal estate tax so that you have both tax-free interspousal gifts and tax-free death-time transfers to the surviving spouse. But if you do that, then in the interest of preventing rather unfortunate results in estate planning and administration, forcing property on spouses to the exclusion of children as well as doubling up estates at a second death, in my opinion you must couple the unlimited marital deduction with a marital deduction for any transfer which provides the donee spouse with current beneficial enjoyment, even though the remainder is not disposable by the donee spouse. This is what I mean by the qualitative expansion of the marital deduction. But this also means that all property receiving the marital deduction in the first estate must be taxed at the death of the surviving spouse as if it were part of the latter's estate.

This does not mean that there will be additional tax on the estate of the surviving spouse. What should occur where there is a life estate in trust for the surviving spouse is that the latter should be allowed to elect whether to qualify the life estate for the marital deduction, so that there will be no tax at the death of the first spouse. Then the tax should be on the marital trust corpus at the death of the second spouse.

By putting the corpus of this marital deduction trust, on which there has been no tax previously paid, on top of the estate of the second spouse, the progressive rate scale will tax it at the top of the rate range applicable to the estate of the second spouse to die, doing it in such a way that it does not require any payment of the tax on the marital trust out of the estate of the second spouse. In other words, the tax is on the trust itself, but at the top rate applicable to the surviving spouse's estate.

I think that you have to provide for flexibility in estate planning. This means that the surviving spouse should be allowed to elect whether a trust in which she does not have the equivalent of absolute ownership will qualify for the marital deduction.

In other words, if the will or trust of the first spouse to die calls for setting up a life estate in trust for the entire property to pass to the surviving spouse with the remainder to the children, then the instrument can permit the spouse to elect to have the trust or any part of it qualify for the marital deduction. This election should be made after the death of the first spouse to die. To the extent that any trust qualifies for the marital deduction, it must then be taxed at the death of the second spouse.

It is true that this might lead to a little complexity because of the election but, gentlemen, if we adopt the proposals that this panel is making and Mr. Eubank just made, of having a $500,000 exemption equivalent to the unified credit, then we are talking about estates of less than 1 percent of the population. This 1 percent can afford to have the complexity, in the interest of giving flexibility. These estates can afford to retain the attorneys to do this job so that they can have a sound estate plan.

The result of abolishing the terminable interest rule will be increased flexibility in both premortem and postmortem planning. There will be no need for people to choose, if they are in second marriages, between the tax benefit of the marital deduction and its potential result of disinheriting their children by a prior marriage because the second spouse has a general power which she can then exercise by appointing the marital trust to a second husband. You will not have to force people to choose between losing the marital deduction or endangering their children's inheritance. Under the proposal, their children from their first marriage can be protected completely and a marital deduction share still be given to the second spouse. The second spouse can either accept or reject the tax postponement of the marital deduction, while retaining the interest itself for her life. In my written statement, there is considerable more details as to how this can be arranged.

What I would like to cover briefly, are two other important points with respect to different aspects of the estate tax law.

The first has to do with the fact that unification of the estate and gift tax laws is not complete. There are several sections in the Internal Revenue Code which are holdovers from the dual transfer tax system which existed prior to 1977. While my written testimony gives technical details about all of these sections, all I want to cover in my oral testimony is the so-called 3-year rule.

The 3-year rule provides that if a gift is made within 3 years of death and if that gift is either a future interest, a present interest in excess of $3,000, any transfer with respect to a life insurance policy or the gift tax paid on one of these transfers, the gift is going to be grossed up into the estate of the person dying with 3 years of making it.

This rule replaced the old 3-year contemplation of death rule, but it is automatic. It creates a number of problems, apart from the fact that it is really unnecessary in a unified tax system, except for those gifts that consist of a tax paid on the gift made within 3 years of tax. Those are gifts which should still be included in the gross estate under the 3-year rule as should transfers made with respect to life insurance policies. But the rest of the 3-year rule should be eliminated. Let me give you a bizzare example that is causing trouble in planning.

The rule basically is a notch rule. In other words, a client can give a gift of $3,000 every year of his life and he can die and the gifts, if they only amounted to $3,000 per year in the last 3 years before this death not only need not be reported—and I am talking about present interest gifts—on gift tax returns, but these gifts need not be grossed up back into the estate.

So let's suppose that on January 1 of the year in which he later dies he gives a $3,000 check to his adult son and then later on buys him a tie for Christmas. He has given more than $3,000. As a result, that entire transfer, which may amount to $3,005, is going to be entirely includible in his gross estate. That is what the law says.

It is ridiculous. We tell our clients to hold their transfers down to $2,900 so they have a little flexibility in case they inadvertently pay a subway fare or a dinner check or something like that. But it should not be the case at all. The rule is archaic and creates other complexities in planning and administration. Therefore, my recommendation is that except for the amount paid in gift taxes on a lifetime transfer within 3 years prior to death and on transfers with respect to life insurance, the 3-year rule be abolished.

The final recommendation that I have has to do with the orphans' deduction. Conceptually perhaps this made some sense, but as it was added by the 1976 Tax Reform Act, it has caused a monstrous mess. It is a complex deduction equal to $5,000 a year for the number of years an orpaned child is under 21. What do you get it for?

You get it for an interest in property that is includable in the decedent's estate that passes or has passed from the decedent to the child either outright or in a form that if the property were going to a spouse, would qualify for the marital deduction. So you must include this in the child's gross estate. It must be includable if it is to qualify.

It is not available if the child has a surviving parent. Both parents have to be dead. And that makes sense. It is not available if there has been a divorce and a parent is still alive. It is not available if the child has been orphaned and the surviving parent has a surviving spouse. That does not make very much sense at all because the surviving spouse is just a step-parent then, unless there was an adoption.

It is available if there has been an adoption except, gentlemen, if the adoption was intended solely to obtain the benefit of the orphans' deduction. I think that is ridiculous. How can you ever prove in court that an adoption was intended in order to obtain the orphans' deduction? It is a laugh.

Interests qualifying for the orphans' deduction include outright transfers and the equivalent, plus some very complicated transfers in trust.

The problem practitioners have with the orphans' deduction is that only a very small minority of estates are going to qualify for it. Since no one ever knows in advance which estate is going to qualify, you have got to put orphans' deduction provisions into every instrument you draw, or at least explain the situation to the client. If you do not do it, you would be acting unethically and not in the client's best interest, but by doing it you create additional work, it costs the client more, et cetera. If you do not do it there may be additional tax should the client die, and an orphans' deduction be available.

Gentlemen, I think that the ambiguities and uncertainties that are inherent in the concept of obtaining the orphans' deduction are so great that unless you can simplify the orphans' deduction so that it can be obtained when you have any kind of a disposition passing to an orphan—and that could be defined reasonably as at present, except with this adoption nonsense and not having an orphan if there is a surviving spouse in the second marriage. If you cannot simplify this so that it is in line with what people normally want to put into the instruments, you should get rid of it entirely.

I appreciate the time that you have given me, and I think that, if some of the changes that we have all suggested in our papers, particularly the major changes that are being stressed orally, are adopted, you will make great progress in the direction of simplification of the system and eliminate a lot of the brakes that currently exist on capital formation hurting the family farm and small businesses.

Thank you very much.

Senator BYRD. Thank you, Mr. Berall.

Mr. Cornfeld?

STATEMENT OF DAVE L. CORNFELD, VICE CHAIRMAN FOR PUBLICATIONS, AMERICAN BAR ASSOCIATION'S TAX SECTION

Mr. CORNFELD. Thank you, Senator.

My name is Dave L. Cornfeld. I am also a private practitioner. I am from the Midwest, St. Louis, Mo.

I, too, want to stress that I am testifying in my individual capacity and that the views expressed are solely my own. They should not be construed as representing the views of the American Bar Association or any other organization of which I happen to be a member.

I want to second the views of the preceding members of the panel with respect to the need for simplification of the laws as a way of cutting down on needless extra work and legal expense for the American taxpayer.

The laws should be made in such a manner that as many taxpayers as possible can handle their intrafamilial economics in a way that they would without regard to any tax law.

As Mr. Berall indicated, husband and wife should be able to transfer funds back and forth and the tax collector should not be interfering with the family handling of finances.

There are a number of suggestions that I would like to discuss that would simplify the present gift and estate taxes and would be consistent with the way people handle their finances in real life.

First, under the gift tax laws, at the present time, there are many technical gifts that are made which are not reported by taxpayers. These are gifts which are made for consumption by the donee.

The typical situation where a taxpayer is furnishing the support of an indigent relative, an aged parent—here there is no legal obligation to do so, but there may well be a moral obligation.

The laws of the various States differ. In some States, a taxpayer will have an obligation to support an aged parent. In most States, he does not, but we should not discriminate against the individual who finds a moral obligation to support a parent or some other relative.

The income tax laws give him a personal exemption for doing that.

At the other end of the spectrum, the gift tax laws say that he should be filing a gift tax return if the amount of that support is more than $3,000.

We also have a situation of support of children, sending them to college. At the present time, tuition at a private college will far exceed the available annual exclusions and yet, in most States, after age 18 now, there is no legal obligation to send that child to college.

Thus, we have a situation where theoretically a gift tax return should be filed. My own opinion is that, in most cases, gift tax returns are not being filed, but we should make the law consistent with the way people operate.

There is a proposal in my prepared statement that was made by the American Law Institute back in 1968 which would treat all such expenditures for support and maintenance of individuals for the use of any person living in the household, any minor child, whether or not living in the household, and the current educational, medical or dental cost of any person not a taxable gift.

In addition to that, I would recommend the exclusion of gifts of the use of tangible property. If I let somebody live in my house rent-free, it should not constitute a taxable gift. Also, there should be an exclusion for a gift of tangible personal property which is going to lose a substantial part of its value by the end of 1 year, with certain limitations—it might be $3,000 or $4,000. If I make a gift to a relative of a television set and also I make a cash gift in the amount of the annual exclusion, I should not have to file a gift tax return. As Mr. Berall indicated, there are many people today who make gifts of exactly $3,000 and then also make some kind of a birthday gift as well. Technically they should be filing gift tax returns and if they die within 3 years the entire amount will be back into their estates.

At the present time, most of these taxpayers are blissfully unaware that they are required to file a return. I would also second the need for an increase in the annual exclusion, but even that increase in the annual exclusion will not solve the problem of the gift for consumption.

There is another problem with the gift tax return requirements in that, in order for a husband and wife to treat their gifts as split gifts under the present law, it is necessary that they file a return. At the present time, there are many, many taxpayers who when asked about prior gifts, say that they give $6,000 every year, but do not have to report it because they can split it with their wives. That is not technically correct.

They must file a return for splitting and that can come back to plague them later on, because once the spouse has died it is too late to file the split return. You cannot file a delinquent return at that time. And at death, the excess over $3,000 will be brought back into their estates if this were to be uncovered.

I would suggest that no return be required in any case where the total gifts of the husband and wife do not exceed the amount that they could give away under the split gift requirement.

At the present time, many of them are not filing anyway. If they did file, it is just one unnecessary operation. They have to go pay to have a gift tax return prepared and at the end of the line there is no tax. This is an area where you could simplify life for the taxpayer.

I would also suggest that the husband and wife should be permitted to split gifts when they do file a gift tax return on any basis that they wish, regardless of the 50-50 requirement. There are situations where one of the spouses may have made gifts in excess of those made by the other. Under our progressive rate structure, or where one may have already used up the unified credit and the other not, they should be permitted to split the gifts so that they can equalize their tax liability, not just equalize the amount of the current gifts.

I want to second Mr. Berall's recommendation as to the unlimited marital deduction. I believe that this would help immeasurably in simplifying our tax structure and it would also eliminate what is a present inequity in the law which hinders interspousal gifts during lifetime. Any time, under our present law, because of a quirk, you make a gift to a spouse of more than $100,000 plus the annual exclusions, there will be a greater increase in the surviving spouse's gross estate for estate tax purposes than will be removed from the donor spouse's estate. As a result, there will be an increase in the overall tax for the family where you have a gift of over $100,000. There is an example given in my prepared statement that shows that a gift of $200,000 out of a $1 million estate, instead of $100,000, would cause an additional tax of some $47,000 in the overall family estate taxes.

This is what happens as a result of a unification of the gift and estate tax laws and, as Professor Casner stated in the ALI project, any time that you have a unified system it will be necessary to have unlimited marital deductions to avoid inequities.

The unlimited deduction would also eliminate the problems involved in joint property. Prior to 1976 in all cases you had a double tax, whenever someone made a gift by buying property and placing it in joint names. There was a gift tax when that was done and the whole amount of the property was included for estate tax purposes.

The 1976 act has changed that in part insofar as spouses are concerned. Now if there is a gift as a result of the joint property, only one-half of it is treated as a gift and one-half is included in the estate for estate tax purposes.

However, that is not true for joint owners other than spouses and in many cases, particularly after one of the spouses has died, the survivor places property in joint names with their children, perhaps in the mistaken belief that they are somehow simplifying the administration of that property. In many of those cases, there is an understanding that all of the income will be retained by the parent and that the parent will control the property. Technically, if that were documented, there would be no gift. Unfortunately, unless they go to a lawyer, there is rarely a documentation of that understanding and on the face of it, there appears to have been a taxable gift which will show up when the estate tax return is filed and the taxpayer subjected to penalties and interest for not having filed a gift tax return.

My recommendation is that, in all instances involving joint property, there should be no gift unless the parties elect to have a gift at that time.

We should have the same treatment for spouses as for joint tenancies between persons who are not married.

At the present time, placing real property in joint names does not result in a gift unless the parties file a gift tax return and make an election. That rule does not apply to personal property. There is no reason to have a distinction between real property and personal property in this regard. People are going to go ahead and take title to property jointly without any advice and knowledge of the gift tax laws and we should simplify those laws for the American taxpayer.

I would like to go back and cover one other administrative problem, which is both a gift tax problem and an estate tax problem, and which is particularly significant with respect to gifts of interests in farms and closely held businesses and which at least for the knowledgeable today may be discouraging such gifts, which should be actually encouraged.

At the present time, if you make a taxable gift and pay no gift tax because of the unified credit, the statute of limitations never starts to run with respect to the valuation of that gift. As a result, if you make a gift in a later year, the Internal Revenue Service can come back and say that the gift that you reported 10 years ago was valued too low ~~and, for~~ the purpose of determining what your bracket is on the second gift, can reevaluate your first gift.

Now that we have unified the gift tax and the estate tax, we have the same problem when the estate tax return is filed because then the Internal Revenue Service can come back and say the total of your adjusted taxable gifts was much more than you had reported on your gift tax returns and the burden of proof in that situation, as in most tax matters, is on the taxpayer. The executor is going to have a terrible job, since the donor is no longer around. It may be 20 years after the date of the gift of the closely held stock or interest in a farm and you have to go back and try to evaluate that gift.

The problem can be solved if, as was the case prior to 1976, the taxpayer would be given the right to elect to waive part of the unified credit so that a tax is paid with respect to that gift. The tax may be small but it will signal to the Internal Revenue Service, come in and audit this return if you want to, and check on the value because we want certainty. If you are going to fight us on the value, let's fight it out now when we have the facts available. Now, I would suggest that if you permit the taxpayer to waive a part of the unified credit that the waiver be made irrevocable so that IRS has some tax to fight about. But I think that it is an important administrative issue.

I want to briefly mention the question of disclaimers. The Tax Reform Act of 1976 put in a provision which actually restricted the use of disclaimers in the case where somebody might not want to receive some property from the estate and would turn it down.

The right to disclaim is important in post-mortem planning, particularly in cases of farms and closely held businesses. The rules should be made uniform. I want to refer to the article by Thomas Wiley of Phoenix, Ariz., which is a part of the prepared statement of Mr. Eubank which spells out the problems in this area better than I could if I had all day. I have also enclosed as an appendix to my statement a recommendation by the American Bar Association which covers the situation and I believe that it is an area that requires some study.

If I may have a few more minutes, I would just like to mention another area of complication which is the new generation-skipping tax that has been put in by the Revenue Tax Reform Act of 1976. This, too, is an area of great complication.

We have no regulations as yet so we do not even know the full extent of the complexity that we will run into in attempting to draw wills for our clients, to let them take care of the members of their family, the natural objects of their bounty.

I have three specific recommendations, one relating to the effective date, because this has created a great deal of complexity in requiring us to amend wills by codicil to be certain that we do not do anything that will trigger the new tax for any decedent who dies before January 1, 1982. Now, I would think that that could be simplified and my recommendation would be that the law not apply to anyone who dies before January 1982 regardless of when they wrote the will and regardless of what kind of an amendment they made to their wills.

At the present time, deleting a specific bequest of $500 to some friend with whom you have fallen out can cause the whole will to be tainted and this is the kind of mistake, I think, that may well have been made by lawyers who were not familiar with the new law.

Senator BYRD. Excuse me. You mean to say that a person could not have put a codicil on a will?

Mr. CORNFELD. If you write a codicil to your will today, and if by so doing you add $1 to a residuary trust which would otherwise be a generation-skipping trust, and if you die before January 1, 1982, that trust will be fully tainted, not just the $1 that has been added to that trust.

Senator WALLOP. By withdrawing the codicil or modifying it?

Mr. CORNFELD. If you modify the will in any respect, which would add anything, $1 to that trust. The law at the same time says if you have a grandfathered, irrevocable trust that was in existence and if you make an addition to it today, only the pro rata part is tainted.

But in the case of a will, if I have slipped up and I have drawn the codicil wrong, I will have made that whole will subject to the new tax. I also think that there should be provisions which would permit members of the family to act as trustees without tainting a trust, where the trustee does not have any opportunity to benefit personally from that trust. At the present time, that is only permitted in very limited restrictive forms. It does not, for example, permit me to have my son act as trustee for a trust where my wife will be the life beneficiary and, at her death, the property will go to my grandchildren. While that trust may qualify for the grandchild exclusion but it will be a generation-skipping trust because I have used my son as a trustee, even though he could never get anything for himself.

Finally, the $250,000 exclusion provision needs changing because it now requires, at least by the committee reports, the vesting of the interest in the grandchild so that it will be subject to estate tax in the grandchild's estate in order to qualify for the $250,000 exclusion. That creates a number of problems and I would think that if the interests of the grandchild is valued by ordinary valuation methods so that it would meet the $250,000 amount it ought to qualify.

Actually, in most instances there will be the equivalent of an estate tax on whatever goes to the grandchild in trust because of the generation-skipping tax on that amount if the grandchild dies and the property goes to the next generation.

I have, in my prepared statement, and I will not take the time now, an instance that I have in actual practice where an elderly couple consulted me and they could not do what hey really wanted to do.

They had an estate of less than $150,000 but that could have been made subject to a tax of $38,000 if they set up the trust in the way that they wanted to for the primary benefit of a retarded granddaughter but where they did not want the granddaughter's estate to get the property but rather wanted it to go to their other grandchildren at the death of that granddaughter.

I thank you for the opportunity to be here.

Senator BYRD. Thank you, Mr. Cornfeld.

Mr. Halbach?

STATEMENT OF EDWARD C. HALBACH, JR., CHAIRMAN-ELECT, REAL PROPERTY, PROBATE AND TRUST LAW SECTION, AMERICAN BAR ASSOCIATION

Mr. HALBACH. Thank you, Senator Byrd.

I am, I guess, on last here to show that there is some break in the uniformity of our views. It could be fairly said that, at least traditionally, I speak more with the mentality of a tax collector than of one representing private clients.

I want to emphasize that I do speak on my own behalf. I am a law professor at the University of California. I do not speak for that institution. I am chairman-elect of the real property, probate and trust section, as was pointed out, but I do not speak for that section or the American Bar Association (which has no position on the matters now before you).

Like the other panelists, I speak on my own behalf.

I believe in a strong estate tax; probably I am more disinclined than others on this panel to see that tax deemphasized.

On the other hand, I share many of the concerns that they have expressed, and this relates not only to the kinds of concerns that Mr. Eubank in particular addressed in talking about the relationship between this tax and the capital base in this country. Formation of capital and the preservation of the capital base, I think, are significant problems today.

Those are complex questions. I am not altogether clear that the most desirable place to give relief is through the estate and gift tax system. Selectively, certain kinds of income tax relief might be as advantageous with respect to capital formation.

I was saddened to note last night that Arthur Okun had died, whom I am sure many of you know and who has contributed in many ways to tax policy in this country. He has recently made some provocative and interesting proposals relating these capital and productivity issues to the problem of inflation and, in part, he suggests consideration of certain kinds of income tax incentives that relate to holding down wage increases and using that additional money for capital formation.

The point I really want to make is that this is a very complex subject, but these issues are related intimately to the estate and gift taxes.

There is one area in which I am very much in harmony with the other members of the panel on, and our views are strikingly harmonious here: The specifics of the estate and gift tax laws are unnecessarily complex.

Sometimes it is impossible to avoid complexity in a tax system that must cope with the risk of skillful avoidance by taxpayers. But I am thoroughly convinced that many of the complexities in the Code are unnecessary—in this body of law, very much unnecessary.

I would like to emphasize that probably throughout the tax field, but especially in the transfer taxes, sumplicit is directly and intimately related to equity.

If you have a tax system that is hazardous even for experts who are mortal, you impose the obvious risks and the failures in their work, even minor ones, can produce enormous differences in the tax treatment of taxpayers who, from a policy viewpoint, ought to be viewed as similarly situated. This is the type of result that follows when you draw fine distinctions between cases that are, from a tax policy viewpoint, substantially identical. Our tax law, in this area, is just overrun with those kinds of distinctions.

Fine distinctions relate intimately to the question of equity. If one taxpayer can avoid the tax impact imposed on another because his or her lawyer is a little more crafty, or the lawyer is fortunate enough to function in a mistake-free manner that day, you get great disparities of treatment between this taxpayer and other who ought to be treated similiarly but whose lawyers were not so skilled or lucky.

Another result of that kind of fine distinction is intrusiveness and economic distortions, plus high cost to the taxpayers. The emphasis on high priced, sophisticated counsel in our tax system is sufficient already without increasing it.

I must say that I look back with amusement on the comments of Assistant Secretary of the Treasury Cohen when he called the 1969 Tax Reform Act the Lawyers' and Accountants' Relief Act. I wonder if he realizes how little relief it gave to the accountants and lawyers who needed it the most, those who are struggling to maintain the level of competency adequate to deal with the problems they see in their practices.

A lawyer is a sitting duck for a malpractice suit, If that competency is maintained, for subjecting his clients to inequities and excessive payment of taxes.

It really has, I believe, gotten to the point where this is one of the more serious kinds of pollution around—the pollution of our Internal Revenue Code. Well-intentioned legislation, well-intentioned regulations have accumulated and added up over the years to the point where nobody really can breathe very easily in that environment. Some of this is attributable to a loss of perspective on the part of policymakers, particularly those concerned with development of regulations.

I listened with the kind of amusement—at least I would chuckle if it were not so painful—when Dave Cornfeld was talking about the codicil and new chapter 13. I was on a small panel that was giving a crash program for lawyers immediately after the 1976 act. Someone in the audience asked if it were possible that the making of a codicil which was revoked before the decedent died would constitute a change in the generation-skipping transfers under the will, thus possibly forfeiting the grandfather protection under chapter 13. Obviously, we felt that it should not be and would not be but one member of the panel said humorously that we nevertheless recommend revocation by burning. We thought that was a joke! The proposed regulations that came out a year ago under those grandfather provisions stated that a revoked codicil would lose you your grandfather protection. Honestly, they did, and we had thought that possibility was funny not serious.

The grandchild exclusion in the generation-skipping tax is another matter of the same kind. The problems, some of which Dave Cornfeld alluded to, some of which were mentioned in Tom Eubank's statement and in mine, are problems that will arise out of the regulation making process.

We know certain things that are going to be contained in some of those regulations which, if there is not a change of position within the Treasury, are going to create some distinctions that simply invite inequity of treatment.

I say this although I, probably more than anybody else in this room, am a believer in chapter 13. I believe, painful though it is, that it was a needed and important change in our transfer taxes. I do not believe in the freedom that we have had in the past to use generation-skipping trusts to escape taxes. I have not relished having to teach students in my classes and lawyers in CLE programs how to exploit the weaknesses in the tax law, including using the traditional generation skipping opportunities, so I thought those changes were needed.

I am a supporter of it, but I too am alienated and offended by some of the things that are being proposed by those responsible for administration and rulemaking under this legislation.

I did not believe, personally, that the statute should have included the quarter of a million dollar grandchild exclusion. But it is in the statute, and it is shocking for the regulations to, in effect, undermine it and to draw the lines between where it is available and where it is not on the basis of unnecessary distinctions that require sophisticated and error free counsel. A lawyer whose intellect was not distorted by careful study and knowledge of the tax laws would make mistakes that would cause his client to be treated very differently from the clients that are fortunate to hire these three people [indicating the other panelists]. If they do not show their mortality by making a minor slip, their clients will get away with all kinds of things that my clients could not. That is why I teach—to get into the ivory tower where I am not such a hazard to my clients. That type of thing in the tax laws is a tremendous shame, and we are seeing more and more of it where it is not really necessary.

Little of what this panel is recommending here today has revenue at stake. Most of our suggestions address defects that are not justified by any concern over revenue, although that is not true of everything. In my observations I shall try to be careful to point out where I believe there are revenue considerations involved. Let me begin with some of those, because they pose some troublesome problems.

Special use valuation, and some issues in tax deferral, admittedly involve difficult problems to be dealt with for farmers and small business owners, but I agree very much with the comments Mr. Eubank made earlier that, we should try to deal with these problems in a generalized way that is not selective, that does not favor one group and, discriminate against another. We need to use more imagination than we have used in trying to deal with the special problems, to the extent that they are special, of farmers and small business owners.

Serious issues arise whenever as you grant a subsidy through tax laws—and I do not mean by that term necessarily to be hostile to all subsidies. Frankly, however, special use valuation and certain deferred tax payment privileges at low rates of interest constitute a significant subsidy. One could very well make the argument that, by placing this subsidy in the estate tax laws rather than somewhere else, we create two general types of problems for ourselves.

One, subsidize only to those people who have inherited opportunities and interests in farms and closely held businesses. If my son and daughter inherit the family farm from me, you give relief to them in their efforts to retain it, so that they are not be as distressed as they otherwise would be by liquidity problems in meeting tax obligations. But the problem is equally acute, and in many respects more serious, for the young person who wants to go into farming but whose father or mother did not have a farm to leave to him.

If we really believe in the family farm and the closely held business, we need to do something to make subsidies more general—or else we should have second thoughts about the subsidy. That does not necessarily mean that what we have been doing in this area is wrong, but I am concerned about the scope of it. I am concerned about the unevenness of it.

Second, if we do have special privileges for certain qualifying taxpayers, the inevitable result is to include highly complex rules for qualification. Those rules operate unevenly even within the target group, the group to be benefited. They may deny eligibility to people who ought to be viewed as similarly situated to some others who do qualify. Unfortunately, unless we are careful and imaginative about the way that we do this, the very eligibility standards will create an incentive for people not to take care of their own liquidity problems. If I have an estate in which my closely held interests or my farm may fall just under the eligibility requirements, I am induced to give away my insurance and my liquid assets in order to qualify. I am thereby encouraged to aggravate the very liquidity problem we are trying to alleviate. Again, I want to emphasize that this is not necessarily decisive of whether we should have these special privileges, although I do have some skepticism myself, but it has a great deal to do with how they are designed if we go forward with them and if we expand them.

These are reasons why I think that general rate relief and increasing the size of the exemption, if there is to be tax relief in this area, is more desirable.

There is another area that several members of this panel have discussed where I find myself a little bit more on the negative side. That has to do with the gift tax annual exclusion.

I very strongly believe that we should not increase the annual exclusion. I recognize the problems that have been talked about, but I do not believe the annual exclusion is now the way to give tax relief. I do not see why such relief should be available only to those who make transfers during life and not at death.

I, myself, have five children. If, in a few years, I am fortunate to get an average of 2 grandchildren per child, and have 10 grandchildren, and if my children are conventional enough to get married to have those grandchildren, I would have 20 prospective donees in the family—5 children, 5 in-laws and 10 grandchildren. My wife and I, because we can give $6,000 to each of them, can give away about $120,000 a year—if we could afford that. That is quite a bit of tax depletion without even having to file a tax return, since I am in a community property State. Elsewhere a married person would merely have had to file tax returns to split the gifts with a spouse.

Certainly we could adjust the gift tax annual exclusion upward. But what it would mean is that one in my situation, if I were extremely wealthy and if my children are grown, could give away about a quarter of a million dollars tax-free each year if you double the exclusion; if you raise it to $10,000 I could give away something in the vicinity of $400,000 tax-free each year.

I think that is a mistake. If we can afford that kind of relief, we would be better off to give it in the estate tax and make it available also to those who financially or psychologically do not feel able to undertake large giving programs. Again, it is selective in a way that tends to be counterproductive. It increases complexity, too. It is easier for me to give away significant amounts if I have marketable securities to fund a large gift program than if I have a closely-held business. Or, if I go through some complex, costly rearranging of my affairs, maybe incorporate my farm, then it may become easy for me to join in that gift program.

That kind of selective relief, I believe, is a serious mistake. I am concerned about the problem that Mr. Cornfeld addressed earlier when he talked about exceptions for what in the American Law Institute studies were referred to as gifts for consumption, including for education. I do think we should make it explicit that those things are not gifts. Nobody reports them now. Nobody attempts to enforce the gift tax law with respect to them. They are de facto exceptions—unless you happen to have a lawyer who is both knowledgeable and scrupulous. Such a lawyer may encourage you to report such gifts. That is a bad way to have tax laws applied and enforced. And the needed changes can be made without excessive complexity.

Let me move to some of the other areas on which the members of this panel apparently agree. I believe the material deductions should be increased, preferably to a 100-percent marital deduction. I think total exemption of inter-spousal transfers is long overdue.

The Treasury itself, the last time that it gave careful study to the estate and tax laws and made its report in 1969, made that recommendation. The Treasury concluded it could afford to open up the marital deduction in that fashion.

There are tax costs involved in that, of course, and I would like to address those in a minute. But there is no place where an investment in the tax system could be more advantageous than through the marital deduction. The costs are far less than one might assume, and that investment can broadly simplify the system and make it more equitable, as no other realistic change in the law could do. It changes the whole background against which other problems are viewed, even on the problems of jointly held property that have been mentioned here and the question of how to deal with employee death benefits. Largely these troublesome issues would be mooted. Thus, a whole array of problems changes character as soon as you open up the marital deduction. Many of the complexities that we now have just simply disappear.

With respect to the simplicity/complexity question, let me emphasize something. When I say simplicity, I am not talking about ease in reading and understanding the terms of a statute; we could learn to understand carryover basis—to understand what is in that statute. By complexity I mean that the better you know the statute, the harder it is to live with. That characterizes carryover basis; that characterizes other objectionable features of the present tax law.

The main objections to the present 50 percent marital deduction are threefold.

One, there is a serious danger of double taxation in a single generation when an estate is not properly planned, because property left outright to a spouse in excess of the marital deduction will be taxed to the first decedent's estate, and that same property is then subjected to another tax when the spouse dies, and the spouse's top brackets.

We do have a credit for property previously taxed, but it declines 20 percent every 2 years and expires after 10; and the average woman in this country who outlives her husband does so by a little over 10 years and the total credit is lost.

That double taxation is serious.

Second, the order of deaths has been referred to. In discussing carryover basis, Treasury spokesmen spent a lot of time talking about the a hypothetical situation in which a truck killed somebody and did not kill somebody else, noting the inequities that resulted under the traditional new-basis-at-death rule because one person lived too long and sold his property before getting a new basis. He thus pays capital gain tax. But the one who died before selling his property could not take it with him but could take it far enough to get it a new basis. His family could then sell without a capital gain.

Tom Eubank and I once had a conversation in which Tom suggested that we should follow that truck around the corner to see it run over another person—the spouse of a wealthy person with substantial separate property. That wealthy person was counting on the marital deduction to produce estate equalization—to split the estate. The way the marital deduction works, however, if the less wealthy spouse dies before the wealthier one, that opportunity is lost. There is another inequity that didn't seem to trouble the Treasury's carryover basis advocates, even though it is easily remedied.

If the property were community property, that equal division of estates is already accomplished. This is a great and more importantly, unnecessary inequity between comparable taxpayers.

Certainly if the taxpayer tries to deal with that by making gifts to his spouse during their lifetimes and to split the estate in time, or if he just does the kinds of things that the other panelists have been talking about innocently—putting property in joint tenancy or in community property form—his is making a taxable gift.

That is the third objection to the limited marital deducation. It is a natural thing for people to place all or most of their property in joint tenancies these days. It happens regularly. With real estate brokers, it is automatic. Stock brokers tell us out on the West Coast that eastern transfer agents do not understand community property, so they have securities issued in joint tenancy form. It is the standard advice given down at the beauty parlor, and now that men go there too, we are all in trouble. It is just a "natural thing" for people to do. This should not be a taxable gift between spouses. It should not have that kind of result, and the limited relief attempted in IRC section 2515 often makes matters worse.

There is a flaw in the gift tax marital deduction, one that creates a problem that you cannot deal with unless you allow a 100-percent interspousal exemption, at least in the gift tax.

That flaw follows from the fact that the gift tax marital deduction is 50 percent of the amount actually given. The estate tax marital deduction is 100 percent of the amount given, up to an aggregate of half the adjusted gross estate. That makes a tremendous difference. If I split my estate with my wife at death, no tax problem; it is tax free, in effect. That is proper and permissible estate splitting. If I do the splitting during my life, however, half of what I have given to her is a taxable gift.

The problem can only be resolved, I think, either by a 100 percent marital deduction or by an alternative that makes gifts during life subject to a complete, 100 percent deduction, possibly with some kind of a section 2035 transfer-in-contemplation-of-death rule to deal with transfers on the deathbed.

Now, on a different aspect of the marital deduction, the terminable interest rule has been talked about earlier. I only want to emphasize that the terminable interest rule is a horror and that it is an unnecessary horror. Again, the 1969 studies by the Treasury itself say we do not need to keep that feature of the law. This is, I think, merely a matter that has not been changed as a result of sheer inertia.

Obviously our congressional committees have very important things to do beyond dealing with the details of these laws, but these are the kinds of things that ought to be developed in the Treasury and put before you. It can be done. It was been worked out before, and revenue is not at all at stake; there is no need to worry about tax loss.

The 100 percent marital deduction does involve some tax loss, most of it merely in the form of revenue postponement. What is a permanent tax loss is the elimination of double taxation, where the Government should not be collecting the second tax anyway. The rest of it is temporary. It puts off the tax from the first spouse's death until the second.

If you would like me to elaborate I can, but the one thing I would like to emphasize is that tax deferral in the estate tax is not like an interest-free loan, as it is in income tax. It is very different.

If you defer the tax on an estate tax, you enlarge the tax base. This compensates the government fully and adequately for the deferral and, given the graduated tax rates that we have, unless your estate is extraordinarily large and has reached the top bracket, the Government will be more than made whole after that deferral.

Finally, let me just say that, with respect to joint tenancy and tenancy in entirety, the serious problems of complexity and inequity in those areas can be eliminated. This can be done even if you do not give a 100-percent exemption for interspousal transfers, by broadening, as David Cornfeld suggested, some of the provisions exempting certain inter vivos transfers. Even more important, this area can be simplified by treating joint tenancies the same as we now treat tenancies in common.

That too was recommended by the Treasury in 1969. There is no need whatever for the present treatment of joint tenancies, which is a very complex statute, now we have unified the taxes. That statute—section 2040—was designed before the taxes were unified. It made some sense then. It makes no sense any longer.

In 1976, we modified the joint tenancy rules a little bit to reflect this. In 1978, we tried further to change those rules. All we have done is to have increased the length of section 2040 and made it more complex. In short, it is needless and pointless; it is easy to correct; and revenue is not in issue.

Next, the orphans' exclusion and the whole subject of disclaimers have been made complex in ways for which there is no revenue or policy justification.

There is no reason why the orphans' deduction has to be subject to the present qualification rules. Literally, the joint committee staff in 1976 tried to allow the so-called family trust to qualify. Literally, they rewrote the statute extensively in 1978 avowedly to authorize the family trust to qualify. It does not. It still does not. They cannot do it, apparently. They have already spent more money trying—and they have not even got to the regulations yet—than could possibly be at stake in that area in the next century. They are "protecting" against a problem that does not exist.

Disclaimers—I can only urge you to take a look at my written statement with reference to disclaimers. I proposed a simple solution to the worst of what was done with the disclaimer rule in 1976. I do not know anybody outside of the current Treasury Department staff that thinks that the changes in the disclaimer rule, especially the one provision that makes it hard to qualify your disclaimer, is sound. People within the Treasury—we have not heard the basis for their view. They did not state why, when it was included in the proposals that came out of the Ways and Means Committee in 1976. It was not even disclosed to Congressmen reading the report that they were making that kind of sweeping change. It was virtually smuggled in, and it is a tremendous change.

The net effect of the provision I urge be deleted from 2518, if I can freely characterize, is that it requires you on your deathbed to see your lawyer before you see your doctor. It is a shame. A person who makes a timely disclaimer should be treated as if the provision disclaimed was never put into the will. It is as simple as that. England has lived fine with a much broader disclaimer rule even than what I am proposing.

Virtually all of the things this panel is suggesting about cleaning up the details of the estate and gift tax law have little or no revenue at stake. Most of them were suggested earlier by the Treasury itself.

Those are the points I would like to conclude with. Thank you very much.

Senator BYRD. Thank you very much, Mr. Halbach. I want to thank all four of you.

I think it has been a very interesting discussion. It is certainly a complicated area.

I have a few questions, then I want to yield to the Senator from Wyoming. First, I want to say that Senator Nelson will be here quite soon. He is very much intersted in this matter.

He had a longstanding commitment in Wisconsin last evening. He is getting the first plane back, and he will be here shortly.

Let me ask you this. I am speaking now of Senator Wallop's proposal—to permit an unlimited marital deduction. Now, Mr. Halbach, I understood your explanation reasonably well.

All four of you have advocated that, have you not?

Mr. EUBANK. Yes, I think all four have.

Mr. HALBACH. Orally or in our statements, yes.

Senator BYRD. I have been under the impression that a 50 percent marital deduction would be adequate. Capsule, if you will, why you think that 50 percent is not adequate and why it should go to unlimited? I know you did it a moment ago. If you could just do it very briefly.

Mr. HALBACH. Let me do it in terms of traditional interspousal behavior.

If I place most of the property that I own in joint tenancy with my wife, I have made a taxable gift now. To the extent that it is land, we can disregard that gift, at least temporarily, under section 2515, which creates some problems that in smaller States are worse than the problems itself. In any event, depending the circumstances—on the types of properties involved and, to the extent it is land, on whether I make an election—either all of this joint tenancy property will be included in my estate for tax purposes or half of it will with the other half treated as a gift for tax purposes. Thus, I am accountable for the full value of the properties one way or another for tax purposes, with the marital deduction probably covering for half their value.

Yet, on my death, the whole of these properties go to my wife, to be included in full eventually in her estate.

The net result is that the whole value is taxed in her estate after half was taxed in my estate. She gets an inadequate credit or no credit at all, depending on how long she outlives me. It is the doubling up of the tax on what might be called half-interest in that property that creates the problem.

There are times when there can be a doubling up of the tax on 100 percent of the property involved.

Summarily, we cannot solve the problems in the gift tax without at least a 100-percent gift tax marital deduction. We cannot solve the problem of inequity and harshness that can result from the "wrong" order of deaths of the spouses without the freedom of transfer that a 100-percent gift tax marital deduction would allow, unless you can find some workable way by which you can give a 100-percent deduction on gifts, up to a total of the value of half my estate, thus allowing estate splitting during life. That we have never figured out how to do, as it is not feasible to track gifts and to value my whole net estate each year of my life as I report my gifts on each return.

Thus, we have never been able to give a gift-tax marital deduction that is actually the equal of the estate tax marital deduction—which, I emphasize, is 100 percent up to 50 percent of the total separate wealth. We have never been able to do that; with the 100 percent marital deduction, either throughout or at least in the gift tax, you would have no problem.

Also, if you think about section 2039, involving employee death benefits, most of those death benefit payments go to the surviving spouse. Part or all of those benefits may be the result of activities in which she supported or aided her spouse to earn and accumulate over their lifetime together.

In those situations we have great complexity in the statute, and considerable inequity of treatment, especially if the pension or other right remaining at the first death is not a qualified benefit. You would not need to draw that difficult, harsh but politically now "sacred" distinction between qualified and unqualified benefits if you had 100-percent interspousal exemption—at least as long as the death benefit went to the spouse,

The point is, the complete exemption of interspousal transfers offers great simplification and equity. Those two major values are at stake, and yet the revenue loss is negligible—mostly temporary. You see, you already allow a 50-percent marital deduction, Senator Byrd; you have already given spouses the privilege of equalizing their estates. That is the main functon of the marital deduction, and that produces already the main tax saving and thus the main revenue loss.

By allowing a larger marital deduction, is it going to be wise for a person with a large estate, to give more and thereby to push the spouse's estate into much higher brackets?

After taking the presently allowed point of equalization, whatever I leave in my taxable estate I save taxes by having it taxed at lower brackets than the level at which by further giving I could add to my wife's estate at my wife's marginal brackets. In other words, to avoid what we call estate stacking, I will not consciously take advantage of the incentive that you offer me if I am wealthy. If someone makes a mistake, however, and leaves the surviving spouse too much, at least the change we propose would alleviate the harsh double-tax penalty of present law. You will have simplified planning and lessened the penalty for error, and for doing what obviously comes naturally with joint tenancy. You also would solve the problems of inter vivos gifts.

Basically, the main revenue loss has already been sustained; it occurred long ago when Congress gave us the 50-percent marital deduction, and then further when you gave us the quarter-million minimum figure in 1976. Martial gifts larger than already covered by that minimum or the 50-percent rule are going to be the result only of mistakes or failures to minimize taxes. They won't be to avoid taxes. You see, we are not going to consciously plan for that result. It would give the government more revenue if we did. Some now do this by error and by planning that is not optimal from a tax standpoint.

All we want to do by these proposals is to see that, when the government gets more revenue this way—when we do overqualify—that the taxpayer is not aggravated; what we seek is merely to take away the double tax. That is the main thing.

Senator BYRD. Your view is, that an unlimited marital deduction does not appreciably affect the revenue to the government in the long run?

Mr. HALBACH. Yes. In the short run, however, it does.

Senator BYRD. As I understand it, let's take an estate of, say, $500,000. The marital deduction would be $250,000 and the estate tax would be in the first instance on the $250,000 remainder.

Then later on, when this other spouse dies, then there would be a tax on that $250,000 plus whatever the spouse picked up from the death of the other spouse.

Is that right?

Mr. HALBACH. Well, if we assume that we start with a half-million estate and I give my wife half of it. Let's say I die and I give my wife half of it. That would bring our estate each to the level of $250,000. I have equalized the estates, because my wife has $250,000 too. But what we have to do now, in order for my wife not to pay another tax on the properties on which I have already been taxed, is that I must refrain from giving that property to her in any form that will be included in her estate. If I give it to her in a fashion that will be included in her estate, then the property will be taxed a second time on her death.

Senator BYRD. If it is not included in her estate, it is not subject to the marital deduction then?

Mr. HALBACH. That is right, but even if it will be in her estate the marital deduction does not cover this; any excess over half the estate in your example. Under the present law, there is no marital deduction if I give her anything over that $250,000. But if I should make a mistake and do so anyway, as in the case of joint tenancy property that passes to her by right of survivorship, or if my will is outdated—I drew my will when it was wise to leave everything to her; now, with inflation, the values have gone up.

Remember the $250,000 figure, when you enacted the 1976 act, was a substantial amount. Today it is a nice home. Pretty soon it is going to be a garage.

We are getting to the point where, in order to pass to my wife a reasonable amount, or even in an estate for which I do not think taxation is serious and so I do not plan for it, I subject to tax in my estate property that will then go into my wife's estate and be taxed again.

What we are asking for is, for the people who do not plan so as to avoid that risk, that you take the double tax off.

In fact, Mr. Berall and some other proposals, would go further. They would say that if my wife has all our properties in her estate when she dies, you should allow an election that would, in essence, permit her to have half taxed in her estate and retroactively throw half back into my estate.

I am not sure that I would urge that we go that far due to the complexities involved for taxpayer and government alike, but at least I would urge you to take the double tax burden off spouses who defectively plan their estates.

That is what we are really talking about, the person who makes a perfectly understandable, innocent mistake now gets hit with an unjustifiable double tax.

You see, we wisely lessened the use of the trust as a generation skipping device in 1976, but your law still requires me to use a trust to avoid double taxation in my generation. It is a peculiar irony. The trust was formerly used to keep the Government from getting its tax bite each generation. Now, we still have to use it to keep the Government from getting a second bite, in a single generation, where tax policy does not and should not seek to take that second bite.

You let me use the trust to avoid the double tax. Of course, you do not say it is against public policy to do so, but with no social economic or tax policy justification, you penalize the person who does not use the trust so as to keep that property out of the survivor's estate.

That is basically what I am driving at.

Senator BYRD. I am not sure I understand that. I will have to meditate on that. I am not sure I totally understand it.

Mr. CORNFELD. An example may clarify your $500,000 estate.

If the estate is properly planned so $250,000 goes to the surviving spouse and the balance is left in a trust where she gets only the income for life—or perhaps gets nothing and then it goes to the children so that it will not be included as a part of her estate—we end up with two taxable $250,000 estates. This assumes no appreciation, that everything stays constant.

The tax, at 1981 rates, would be slightly under $24,000 on each estate or a total of $48,000.

Now, if we follow this unlimited marital and you actually use the unlimited marital and you pass the whole $500,000 to the surviving spouse, we would have no tax at the first death. But at the second death, there would be a $500,000 estate on which the tax would be $108,000.

So that you can see that the difference is about $60,000 more tax to the Government. If somebody took full advantage of the marital, even if somebody under that rule would have left $175,000 so it would not be taxable, we would reduce that extra $60,000 by $47,000. There would still be $13,000 more overall tax to the Government on both deaths as a result of the unlimited marital, even in an estate as small as $500,000, so that the Government loses $24,000 on the first death but picks up that $24,000 plus an additional $13,000 on the second death, I think that would more than offset any interest charge on that deferral.

If the arithmetic is followed, and the Senator will study this, there is an inescapable conclusion that there really should be no loss to the Government other than in the situation under today's law where somebody is just ill-advised and makes a mistake.

Mr. HALBACH. If the individual makes a mistake today, and even with an unlimited marital deduction, pushing the property all into one estate. But what happens now, and what we would seek to avoid by a full marital deduction, is that you also pay tax on the first death, and that really aggravates the problem. With an unlimited marital deduction, at least you get rid of the tax on the first estate. Most people would not take advantage of it, but if they did by mistake, the penalty would not be as extraordinary as it is under the present law.

Mr. BERALL. Three other points which should be mentioned here, in summarizing the points that Mr. Halbach and Mr. Cornfeld just made, are that, first of all, an unlimited marital deduction, like any marital deduction, is not a real deduction but a postponement of the tax. The Government will pick up this tax in the same generation, at the death of the surviving spouse.

Second—and again, I am talking about the quantitative expansion of the marital deduction—the unlimited marital deduction will go a long way to bringing the tax system into line with what most people seem to want, particularly people who have moderate-sized estates. They want to leave everything to the spouse. If we let them do that with an unlimited marital deduction, we may be postponing tax but stacking the surviver's estate into higher brackets. But at least we are conforming the tax laws as to what most of our clients in the lower brackets seem to want.

The third point I want to make has to do with the qualitative marital deduction. Perhaps I feel more strongly than other members of this panel, that it must accompany the unlimited quantitative expansion. That is not going to cause the Government any great loss in revenue, although you are still postponing the marital deduction, but what you are permitting is that the person who has subsequent marriages—and today, we find that maybe one out of two marriages end in divorce rather than death and people do remarry—these people should be able to protect the children of their first marriage while obtaining a marital deduction. There should be some flexibility here in estate planning to allow elections after death, if they want the unlimited marital and want the marital to apply to just a life estate.

These can all be put into the tax law without causing major revenue losses and without causing great complexity but they will allow more flexibility for people.

Senator BYRD. The great reason, as I see it, for a change in the present estate tax law is what you mentioned about a home.

Now, the price of a house has gotten so great now, and it is going up all the time because of inflation. In the example I developed, at a 9 percent inflation rate, a $70,000 house today would be valued at $421,000 20 years from now. Twenty years is not very long, really.

And if a person died owning a home, and $100,000 in other assets, that is $521,000 on which the widow would have to pay a tax.

And I would assume that most families would have to sell the house in order to be able to pay the tax, and if you sell the house, you have a capital gains tax on it.

If you sell it 2 or 3 years later, something like that.

Mr. EUBANK. I think you have hit the nail on the head, Senator. It is that kind of problem that led you to focus on rate reductions and a substantial increase in the unified credit.

Already people are hitting those situations. That house has not appreciated that much yet, but we can see it happening. We can see it is right around the corner, and it takes time to get new bills through, and the time to start is now.

Senator BYRD. Well, one other question about Senator Wallop's bill. He proposed to increase the annual gift tax exclusion from $3,000 to $6,000.

Mr. Halbach opposes that, as I gather. The other three of you approve it, except you would take it up to $10,000?

Mr. BERALL. I would advise that, Senator, in light of inflation, but I would also stress that Mr. Cornfeld and Mr. Halbach pointed out that the transfer for consumption problem should be taken out of the ambit of the gift tax laws.

And college tuition at high cost colleges of about $9,000 a year should not be a transfer that requires a gift tax return to be filed, or a gift tax paid.

Senator BYRD. Are you saying if a parent today sends his 18-year-old or 19-year-old daughter or son to Harvard, Yale, what have you, at $9,000 tuition, then the parent owes a gift tax on paying that tuition?

Mr. EUBANK. Apparently that is the law in many States. Under the Federal laws that is so because that child is now an adult in most States and under the laws of most States, the parent owes no legal obligation to support an adult child.

So if the parent pays those expenses or gives the money to the child for those expenses, apparently that is a gift.

Senator BYRD. That does not seem very reasonable to me.

Mr. CORNFELD. Or to us.

Mr. HALBACH. I am concerned about the same problem. My point of disagreement is that I believe we can and should deal with this problem by expressly exempting transfers for education and consumption. That would also take care of supporting an elderly parent and all kinds of other situations.

The reason I hesitate to see an enlarged annual exclusion is that it then becomes so broadly usable even beyond the purpose you are discussing, to the point where it is a means of transference of wealth, not of support, not for need, but really transferring large amounts of wealth tax free.

If you want to give relief there, I would rather see you exclude such transfers than to see you put in an enlarged exemption for gifts generally; the latter requires me to go after that special privilege during my lifetime but doesn't allow the tax break to those who can't or don't give wealth away until later. That is my main concern.

I have no hesitation at all in saying that we need to do something to liberalize the opportunity to give money for consumption, education, support, and that sort of thing. It is only the significant enlargement of the transferee's estate through tax-free channels that I was concerned about.

The goal of the annual exclusion was to keep the Internal Revenue Service out from under the Christmas tree. I think $3,000, now enlarged by gift-splitting is adequate for the purpose—even on a wedding you have two donees, not one. If you are having a wedding, you have a son and daughter-in-law, or a daughter and son-in-law; that means $12,000 my wife and I could give the couple without even blinking an eye.

Now, if I were to plan carefully, even if I want to give them a $20,000 automobile, I can give them half at Christmastime and half after the first of the year.

There are a lot of possibilities to accomplish reasonable objectives without opening this thing up too widely. That is what I sought to avoid by emphasizing an exception for consumption and education rather than a direct enlargement of the annual exclusion.

Senator BYRD. The $3,000, as I recall it, goes back to about 1942.

Mr. HALBACH. 1942.

Senator BYRD. It goes to the value of the dollar in 1942 and 1980. It is considerably different.

Mr. EUBANK. Senator, we are all in agreement that something needs to be done with this gift tax exclusion. We do have a difference as to what ought to be done.

We are all in agreement that it ought to be liberalized. Ed Halbach said the $3,000 amount should not be changed, but the problems should be taken care of through a gift-for-consumption approach.

I guess I am at the other extreme. I suggested simply a dollar increase to something above $6,000. I have suggested about $10,000 without any gift-for-consumption exception, which I think would be fairly complicated. The exception would probably be workable, but a $10,000 exclusion would be a lot simpler.

That is the reason I took my approach.

Senator BYRD. I guess most 19- or 18- or 20-year-olds except those who are out working on their own, they are either in college with the parents paying the tuition or they are living at home, and I guess technically, under the present laws you have to charge them for rent, for food and for everything else.

Mr. EUBANK. Certainly that is unclear.

Mr. HALBACH. It is at least arguable.

Senator BYRD. Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman. I have only a few questions and I really wish in many respects that I could sit here and listen to you gentlemen all day because it's a very informative panel.

I gather when anybody talks of the existence of either gift taxes or inheritance taxes that most people really don't view that from a revenue standpoint. Is that a fair characterization?

Mr. HALBACH. I think so. As a matter of fact, even the economists most favorable to these taxes say that if you're after revenue, this is a very clumsy and wasteful way to get it.

Senator WALLOP. So that in theory it exists for a social purpose and for others, because they're afraid to say that they don't approve of that social service.

If it is primarily a matter of social purpose, Mr. Halbach, with regards to the gift tax exclusion, any kind of diffusionary giving such as you've mentioned, where you could give away up to $100,000 a year if you had enough generations down there, wouldn't that be achieving the social purpose? In other words, you are not passing on any huge family economic power by spreading $3,000 gifts all through the dozens of generations.

Mr. HALBACH. Well, in a way that's true. On the other hand you can say the same thing about enlarging the exemption at death, which I would prefer if you feel we can afford to move in that direction. The thing that I'm troubled about is giving that benefit only to the people who undertake an extensive gift program during their lifetime.

I think for example it's very difficult——

Senator Wallop. It isn't really a benefit, though, in terms of trying to maintain an estate, which is at least part of what we're seeking to do here by these proposals.

Mr. HALBACH. Well, in the example I used earlier, if you enlarge this exclusion to the point where I can give away $400,000 a year and if I do that over a 10-year period, even without compounding that's $4 million. My point is that I don't know see why I should get that benefit when you, who don't undertake such a gift program would not get the benefit of a proposed liberalization. The benefits will be entirely for the very wealthy. I don't see why that money shouldn't be used to enlarge the transfer tax exemption for all.

The reason a particular person may feel unable to take advantage of the opportunity you propose may be because he or she has an unincorporated farm and it's not so easy to give that away in a practical way, especially to minor donees.

Thus, I think you invite the relief to go the wrong way with an enlarged gift tax exemption.

Senator WALLOP. I have a hard time seeing that, as relief in terms of the ultimate effect of what it does. But if all of these proposals are basically designed to achieve a social purpose, one of the so-called social purposes of the country has been to avoid urban sprawl. One of the so-called social purposes of the country is to maintain the productive farmland in production as long as we can, not so much for the families but for the future of the country.

What happens now, and one of the reasons that my bill focuses a little more on agriculture than on general taxes, though I understand the equity that you're talking about, is that people are forced into subdividing agricultural lands as a means of settling estates simply by the fact that there is no other way. Either they sell the whole farm or somebody else does it.

That was one of the reasons that my focus went, as well as small businesses, to the agricultural purposes. It tries to satisfy another national social purpose and goal, that is, to find some means of not running contrary to what is otherwise the national policy. Something that I believe in very greatly is that the country really can no longer afford to force the subdivision of agriculture.

Could you comment on that, any of you?

Mr. HALBACH. I would only say, I think that such a goal was better pursued under the Town and Country Planning Act in England than it would be to do it in the relatively selective way that's involved here. I'm not sympathetic to the special problem involved here, but what troubles me again is the selective way in which this relief is offered. If a person doesn't have a family member interested in farming, I would still think it would be important if you really want to keep that land in farming, to make your subsidies broad enough so that another purchaser with a family farm interest could reach it.

That's the trouble I have, you see, with doing it through the estate tax rather than some more general subsidy.

Mr. EUBANK. Senator Wallop, let me comment also on that. I think your point is well taken that there are special problems and special needs in the case of farms. One of the things that struck me as I prepared for today is that some of these things exist in the case of other estates, too. Take for example, a closely held business that's not based on real estate; many of the same very considerations exist there.

The most acute problems, though, exist in the case of a farm.

Senator WALLOP. And I would agree with you, and still do in many respects up until about 3 weeks ago when you start seeing interest rates the way they are now. Nobody can borrow enough money to keep the family drug store in business long enough to satisfy an inheritance tax.

Mr. EUBANK. And the problem extends to the personal residence, as Senator Byrd was talking about. It's going across the board, and that's what led me to start with the idea of a reexamination of the rate and credit system. Then we can turn to special situations and special needs later.

Senator WALLOP. In light of that, Mr. Eubank, would you keep the 70-percent maximum?

Mr. EUBANK. I address that in my prepared remarks. That is a difficult one. I think it needs reexamination from time to time. I personally believe that the estate tax ought to be very heavy in the case of the very large estates because of the social concerns, but what is a very large estate? I think that's what varies from time to time.

It used to be, if you go back long enough, that a $2 million estate was enormous. It's still a lot, but we reach the maximum now at $5 million, and I think that that needs reconsideration. It may be that Congress would think that it ought to be left there. It may be that the magic number ought to be somewhat higher than that.

Senator WALLOP. Mr. Chairman, that satisfies me. I may have some written questions after I've had a chance to review all your testimony. If that's all right, I would like to be able to ask for your cooperation.

Mr. EUBANK. We'd be happy to respond to any additional questions.

Senator BYRD. Before this panel leaves and we have another panel, I don't know whether you commented specifically on two pieces of legislation introduced by Senator Nelson. Both of these grew out of recommendations by the White House Conference on Small Business. Incidentally, one reason for this meeting today is to consider some of the proposals made by the White House Conference on Small Business.

Now S. 1825, introduced by Senators Nelson, Pell, Roth, Cranston and Packwood, would not establish a permanent mechanism for adjusting the estate tax exemption for inflation? However, it would increase the exemption for 1979, 1980, and 1981 to account for inflation since 1976. So that in effect would be, I guess, an indexing for that period of time.

Now the second proposal, S. 2220, introduced by Senators Nelson, Baucus, Heinz, and Stewart, would increase the exemption to $500,000 for certain family-owned businesses.

Do any members of the panel have comments on either of those or both?

Mr. EUBANK. I might make a brief comment here. I can see the need and the pressure for that kind of relief involving farms and family businesses. This would be a new kind of increase, with a $500,000 ceiling on it.

My first answer is that we need a general rate reduction, and then we can start looking at problems like those new reliefs. There are needs for new reliefs, but there are problems with that kind of approach. It's another inroad into a general rule of estate tax valuation on the basis of fair market value. We've already got inroads into that, and there is pressure for more inroads.

The purist in me says that we ought to try to resist those inroads. On the other hand, the practical in me says that some need relief and some may have to get it that way.

I wonder if that's the best way to give them the relief, and I suggest we look at this special relief after a general rate reduction, or in conjunction with it.

Mr. BERALL. I think, Senator, that a procedure which I might, with all due respect to the committee, suggest concerning the amendment of the estate and gift tax laws is that you consider putting these bills together into an omnibus bill which would contain the general rate reduction and the increase in the exemption which are nontechnical provisions with the most widespread effect on the country. Then flush out the bill with a great many of the technical suggestions that we have made in our various submissions here, particularly in the area of the marital deduction and the expansion and liberalization of the extended pay-out rules which are beneficial not just to the farms but to small closely held businesses and other illiquid estates.

And I think that this comprehensive revision in bill form is something that could be looked at very carefully as it goes through the Congress. Whether you try to put it on to a bill coming over from the Ways and Means Committee or whether you try to have it originate there is a matter of procedure that obviously the Congress has to decide. But I think you really do need comprehensive revision of the estate and gift tax laws along the lines we discussed and starting—I agree with Mr. Eubank—with the rate reductions and possibly even raising the rates in the estates over $10 million above 70 percent because of the social purposes of the estate tax.

Then I think once you've done that and you've raised the exemption, you continue looking at the marital deduction and the other technical provisions, as you put this comprehensive revision together.

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Senator BYRD. In other words, it's suggested that possibly the two proposals of Senator Nelson, or at least one of those, and I don't suppose you'd necessarily want both, and the proposal of Senator Wallop could be meshed into one and in the meshing process take into consideration a change in the rates?

Mr. EUBANK. Exactly.

Senator BYRD. Thank you gentlemen very much. It's been a very worthwhile discussion, very helpful to the committee. The committee is appreciative for each of you being here.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 224.]

SUMMARY OF STATEMENT BY J. THOMAS EUBANK

[This statement is made by me as an individual and not as a representative of any firm or organization. I am engaged in the private practice of law at 3000 One Shell Plaza, Houston, Texas 77002.]

I start with two central themes: the difficulty all taxpayers are having in paying estate taxes, not only as to farms and other family businesses but as to all properties; and the difficulties most taxpayers are having in complying with the tax laws and the need for simplification.

1. The rates and inflation.—The effect of inflation and progressive estate tax rates is examined. Alarming estate tax increases are found, even if allowance is made for the decreased values of dollars used to pay the taxes. This is especially true for estates around $250,000 in value. Many estates exempted from tax in 1976 are now subject to tax because of inflation.

2. The rates and special use valuations.—Needs and pressures exist for more relief as to farms and other family businesses; but many of the reasons for relief apply also to all estates. Those needs and pressures signal generally that estate tax rates are too high for everyone. Special problems remaining as to farms and other family businesses after a general rate reduction should be determined and considered.

3. The rates and the fundamental purposes of estate and gift taxes.—Those fundamental purposes are to tax the very wealthy very heavily because of social and economic concerns. They do not apply today in the case of a $500,000 estate or even one of $1,000,000 or $2,000,000. Estate taxes affect the viability of our private sector economy and should be reconsidered in the light of fundamental purposes.

4. The outline of a basic proposal.—(a) Increase the unified credit to an exemption equivalent of $500,000. Thereafter, start rates at about 25 percent, increasing slowly to about 35 percent at $2,500,000. (b) Revise and rethink special use valuations. (c) Merge and liberalize the two provisions enabling a deferral of the estate tax as a matter of right. (d) Change the section regarding stock exemptions to pay estate taxes to its form before the 1976 Act. (e) Liberalize the rates of interest on estate tax deferrals. (f) Increase the gift tax annual exclusion to $10,000.

5. Keeping in mind some 1976 tax increases.—When considering rate reductions and a unified credit increase, keep in mind that the unified transfer system adopted in 1976 had the effect of substantially increasing taxes for many taxpayers.

6. An unlimited marital deduction.—This is an old idea, whose time has come, partly because of social concerns. Free transferability between husband and wife would enable many individuals to give legal effect to their basic feeling of marital partnership and morality. It would offer a temporary solution in the case of farms and other family businesses, when one spouse dies. No revenue loss should occur in the long run. Massive simplification would result.

7. Additional proposals.—(a) Simplify the orphan's deduction or repeal it. (b) Amend the disclaimer provision to follow the 1974 American Bar Association proposal or the 1968 American Law Institute proposal. (c) Solve some troublesome problems with the statute of limitations that resulted unexpectedly from the unified transfer system and the new generation-skipping transfer tax. (d) Delete most of the provision regarding transfers within three years of death. (e) Prepare to correct, at some date in the future, numerous problems under the new generation-skipping transfer tax.

PREPARED STATEMENT OF J. THOMAS EUBANK

In preparation for today, I talked with a number of lawyers from coast to coast, asking them about important reforms needed in federal laws pertaining to estate and gift taxes and related income taxes. Answers I heard often involve farms and other family businesses, special use evaluations, and estate tax deferrals. Although the points were specific and sometimes technical, a central theme underlying most of what I heard is that severe difficulties are being encountered in paying estate taxes, as they become due or, if deferred or financed, when installments become due. It soon became apparent that this central theme is not confined to estates consisting primarily of farms and other family businesses, but instead extends increasingly among all estates now taxable under the federal laws.

Another central theme I heard involves complexity and difficulty in complying with the tax laws in spite of all reasonable efforts to comply.

The estate and gift taxes have unusual features when compared to other taxes. They produce only about $5 billion a year, less than the excise taxes on alcohol and tobacco. Yet, they generate enormous problems and concerns among taxpayers. This is because of the crucial and often devastating effect they have on the family, coming as they do unpredictably on the death of a member when the family is often at its weakest, psychologically and financially. Moreover, from a national viewpoint, the estate and gift taxes constitute a substantial tax on capital in the private sector economy, aggravating problems there having to do with the economic strength and productivity of this nation. These effects are the reasons why Congress and the taxpayers have had, and will continue to have, such concern and interest as to these particular taxes.

A subject I emphasize today thus has to do with the estate and gift tax rates. An encouraging feature of this subject is that it leads to the possibility of simplifying the laws and enhancing both compliance and enforcement connected with the laws.

1. The rates and inflation.—First, I approach the subject of rates with inflation in mind. Every member of Congress doubtless is acutely aware of income tax increases produced automatically by the high rate of inflation experienced in recent years, as it triggers the higher progressive rates. It may be that some in Congress have not yet focused on the same phenomenon in the case of estate and gift taxes. Estate and gift taxes are increasing too, even when measured in constant dollars, as a result of inflation and progressive rates.

Attached to this statement is Appendix A, which graphically illustrates this tax increase. There I have included a $250,000 estate on January 1, 1977, when the current rates became effective, and have looked at the same estate seven years later on January 1, 1984. If one assumes that the inflationary rate during each of these seven years is 10% and that no change in value has occurred except an increase commensurate with inflation, that $250,000 estate will be a $500,000 estate at 1984 with no real increase in value. The tax on that estate will increase from $23,800 in 1977 to $108,800 in 1984. To produce an accurate measure of the effect of inflation alone, a unified credit of $47,000 has been used in all calculations, even though the credit was less than in 1977. Some would note, however, that because of inflation, the tax in 1984 is payable in fifty-cent dollars when compared with the tax in 1977. Thus, to measure the tax increase in constant 1977 dollars, the $108,000 tax has been halved in Appendix A to $54,400. The tax increase in constant dollars is thus from $23,800 to $54,400, which is, most would agree, an alarming increase that Congress probably did not intend in 1976 when it enacted the present rates.

In Appendix A, I have been shown similar calculations for 1977 estates ranging from $250,000 in value to $2,500,000 in value. An interesting pattern develops. With constant 1977 dollars, the tax increase for a $2,500,000 estate is 28 percent. This percentage tax increase drops as the estate size is lowered, until it reaches 22 percent for 1977 estates of $1,250,000 and $1,500,000. Then it starts increasing dramatically as the estate size is lowered further. In the case of a 1977 estate of $500,000, the percentage increase is 37 percent. In the case of a 1977 estate of $250,000, the percentage increase is an alarming 129 percentage. Stated differently, the tax on the estate increases from 10 percent of the estate to 22 percent of the estate, without any real increase in the size of the estate.

Appendix A leads to several important conclusions. One of the combination of inflation and rate progressivity creates problems calling for downward adjustments in rates throughout the schedule, if the basic level of taxation set in 1976 is to be maintained. Second, the unified credit that will reach $47,000 in 1981 is in need of adjustment upward, because its static character relative to inflation and rate progressivity is what producers the dramatic increases at the lower end. Third, the need for adjustments is greatest in the case of estates shown at the lower end, specifically, estates between $175,625 and about $500,000. Four, inflation has had and increasingly will have the effect of moving many 1977 nontaxable estates, those below $175,625, into the taxable category, this taxing a great number of estates Congress did not intend in 1976 to tax.

In 1976 Congress laudibly exempted estates between $60,000 and $175,625 from the estate tax process. There was no need to subject those estates to the tax and to the expenses, delays, and uncertainties inherent in the estate tax process. This major improvement will be largely lost by 1984 unless adjustments are made, for a 1977 estate of $88,000 will otherwise have entered the taxable category by 1984 under the assumptions used in Appendix A.

Periodic adjustments in the rates and the unified credit thus are essential. The time to start the legislative process is now. We are now about halfway through the seven-year period. There is, of course, no reason to await the end of the period, which is only illustrative. We know that the need has already arisen, especially with a 13 percent rate of inflation last year and one that may be even higher this year.

When calling for periodic adjustments, I am assuming that Congress is not willing now to index the unified credit and either values or the rates. Indexing in one area, of course, would generate pressure to index throughout the tax system. If that assumption is wrong, then indexing should be considered as a more precise alternative to periodic adjustments.

2. *The rates and special use valuations.*—Second, I approach the subject of rates with special use valuation in mind. In doing so, I focus on how the purposes and problems which led Congress in 1976 to enact section 2032A now lead to a number of changes, including a reduction in estate tax rates and an increase in the unified credit.

The reasons given for enacting section 2032A include these from a 1976 committee report:

Your committee believes that, when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, your committee believes it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely held businesses.

Another reason that could have been given is based on the unity concept. The sale of some of a farm or other family business to pay the tax often is not feasible because the remaining portion would not be a viable economic unit, thus necessitating a sale of all rather than just a part of the unit if any sale must be made. Whereas, in the case of marketable securities, it is often feasible to sell some of the holdings to pay the tax and to keep the balance.

How is section 2032A working? In some instances, it is working so as to grant substantial relief. In others where relief was intended, it is working slightly or not at all. In those instances not within the ambit of the section but with many of the same problems, it is, of course, working not at all. Overall, it is working spasmodically and with great unevenness. Only temporary regulations are available, and those cover only three areas among many. Many estates which have elected to use section 2032A have found their reductions in value denied or delayed because of administrative problems. One such problem arises when the practice in a given area is to lease farm land on a crop-sharing basis rather than for cash. The Internal Revenue Service apparently is taking the position that capitalization based on cash rentals under section 2032A is not available in those areas, because crop-sharing cannot be equated to dollars in order to determine the average annual gross cash rental for comparable land used for farming purposes and located in the locality where the decedent's farm is located. Some of these problems are addressed in bills before this Congress, such as S. 1984 and 2220, which include expansions of the valuation relief now existing.

Reductions in value as to farms having a determinable cash rental are as much as 70 percent below fair market value. In those instances, the section is working so as to grant substantial relief.

Reductions in value as to farms not having a determinable cash rental, for example those in an area where crop-sharing rentals are prevalent, are either nonexistent or very slight. The indications are that under the five factor formula set forth in section 2032A(e)(8), no reduction is possible as a practical matter in many instances, while some believe that reductions not exceeding 20 percent may be possible in some instances.

Family businesses other than farms can receive no valuation reduction except under the five factor formula. As indicated, any reduction there is non-existent or very slight.

We must not forget the many estates which need relief and come within much of the general rationale behind section 2032A, but which do not come within the narrow confines of that section. There are the near-miss estates, which almost qualify but fail slightly, as well as other family businesses which section 2032A simply is not intended to cover. Many of the reasons for section 2032A are applicable also in the case of near-miss estates and other family businesses.

Also, there are the estates primarily consisting of marketable securities. Why should an estate with a farm or other family business be preferred in the tax laws over an estate with neither but with marketable securities in the business corporations of this nation? The importance of holdings in these securities must not be overlooked if we are to have a private section economy adequate for the needs and growth of this country. In view of the problems noted above as to farms and other family businesses, my question thus becomes whether some relief to some extent is not needed in the case of other properties, such as marketable securities. After all, some of the reasons noted above are applicable also in the case of marketable securities. First, it is desirable to encourage the continued ownership of marketable securities in the private sector. Taxing them transfers a portion to the public sector, where that portion is spent and dispersed in a manner which does not result in a return of all of that portion to private sector capital. This reduction in private sector capital can be made up only by productive increases in private sector capital or by infusions of after-tax income into private sector capital; and that is not occurring now as much as the nation needs. There is a widely-recognized shortage of private sector capital, which has led to a decline of our nation's productivity. Second, some marketable securities, like some farms, have low income potential that is insufficient to service extended tax payments or loans obtained to pay the tax.

Strong needs and pressures thus exist to clean up, and even to expand the ambit of, section 2032A so as to solve problems and to produce more evenness and fairness. These needs and pressures signal generally that estate taxes are too high. The answer is first to reduce the estate tax rates and to increase the unified credit as to all taxpayers. In conjunction with and in the light of the reduced estate tax rates and an increased unified credit, the entire package of relief provisions for special situations should be re-examined to determine the manner and extent of relief still needed under the reduced rates and an increased unified credit. That reexamination should include not only special use valuations under section 2032A, but tax deferrals under sections 6166 and 6166A, limited exemptions under section 303 from dividend treatment, and low interest under section 6601. An important opportunity may exist here to simplify the laws and to enhance both compliance and enforcement connected with the laws.

3. The rates and the fundamental purposes of estate and gift taxes.—Third, I approach the subject of rates with the fundamental purposes of estate and gift taxes in mind.

Although it is clear that the estate and gift tax laws were never intended primarily to produce revenue, the legislative history of those laws includes only sparse statements of fundamental purposes. At an American Assembly program during December of 1976 on "Death, Taxes, and Family Property," those purposes were examined in depth, and this summary was published:

Americans who acquire and hold property express themselves in the way they deal with it: using it, spending it, saving it, giving it away. The social order around us tends to honor our choices on the basic theory that private decision making is better than public control. To hold property and to have wide discretion over it are closely associated with our concepts of freedom.

One's property rights, however, are not absolute and accommodations must be made to the interests of others in society. Care must be taken that wealth does not give rise to excessive power—that is, the power unduly to limit economic opportunity or to govern the lives of others.

One aspect of private property, and a traditional area of free choice, has occupied this Assembly's attention: the right of succession and the freedom to dispose of property during life and at death. The Assembly has examined the extent to which that right and that freedom should exist or be limited.

Intervention by society is justified to curtail harmful concentration and perpetuation of economic power. In addition, freedom of testation may be regulated so that property is not given to persons or in forms that are believed unfair to family members or otherwise socially undesirable.

SOME BASIC PREMISES

Much of the law of succession has origins in the past, some of which are no longer compelling or relevant.

We are concerned that much of today's law and even some recent legislation, including tax legislation, has developed without adequate analysis of fundamental reasons for or against public intervention.

Our systems of wealth transfer can be appreciated, or property altered, only after their premises, structures and procedures have been subjected to philosophical inquiry, testing them against economic, social and political values of today. The Assembly has attempted that, with particular emphasis on the transfer of substantial wealth from one generation to another.

The institution of succession serves a variety of values cherished by a free society. These include reinforcement of family ties and responsibilities, economic and social pluralism, and encouragement or private philanthropy to improve the quality of life.

At the same time, transfers of substantial wealth tend to conflict with other basic social values, including equality of opportunity, dispersal of economic power, reward according to merit, and avoidance of rigid class distinctions.

Perhaps at a more fundamental level, the institution of succession is a proper response of society to elemental motives, ranging from concern for one's immediate family to a desire to extend one's personality beyond death. In fact, established patterns of inheritence may be the least objectionable means of deciding property ownership on a person's death.

Excessive unearned wealth, however, may arouse deep-seated resentment, and possibly alienation from society, over someone's "getting something for nothing."

Examined from an economic perspective, the right to transfer wealth has the positive values of fostering incentives in the form of rewarding industry, ingenuity and creativity, encouraging capital formation through saving and investment, permitting continuity of on-going enterprise, and supporting diversity in priorities. In addition, such transfers are, indeed, often justified by significant, if but not always evident, economic contributions by those who receive them.

There also may be adverse economic implications in permitting significant wealth transfers, including loss of potential tax revenues, tolerance of continuing concentrations of economic power, inefficiency in investment resource allocation and reduced incentives to productivity among heirs.

It should be noted that there was not in this Assembly, any more than there is in American society as a whole, a consensus concerning the amount of individual wealth to be considered objectionable when one weighs the particular positive and negative qualities enumerated here. It was frequently suggested that the impact of those qualities may vary considerably depending upon the character and dispersion of the wealth transfers involved. It would appear that limitations on wealth transmission ultimately will be set by political judgments rather than solely by a process of reasoning and logic.

TAXATION OF WEALTH TRANSFERS

There will continue to be a call for the relatively modest revenues generated by transferred taxes, but a realistic assessment of the justification for these taxes must focus on their role in redistribution of wealth. This fact, however, does not lead us to a conclusion that the goal of redistribution, in light of other relevant social ar economic considerations, now justifies either an increase or a decrease in the present levels of death and gift taxation.

Three years of changes since that summary, the ravages of inflation, and further thought about those fundamental purposes have all led this participant in that American Assembly program to the conclusion today that fundamental purposes and consideration justify, and require, a decrease in many of the present levels of estate and gift taxation.

The fundamental purposes of the estate and gift tax laws are to tax the very wealthy very heavily, to limit undue concentrations of wealth and power in a few, to break up those concentrations, and to enhance equality of opportunity. Without doubt, those purposes apply today with respect to very large estates. The highest estate tax bracket, 70 percent, is reached at $5,000,000 today. Whether the highest bracket should be reached at $5,000,000 today is a question worthy of consideration; but the very large estates are not my concern today. The more modest estates are my concern.

In view of the fundamental purposes of the estate and gift laws, which I believe have been neither stated well in legislative histories nor observed well when laws were written, I now ask whether it is proper to tax a $500,000 estate very much.

What about a $1,000,000 estate or even a $2,000,000 estate? Are those really concentrations of wealth and power that we want to break up significantly? Are not those holdings the very backbone of the private sector economy that we wish to preserve, because they are large enough to include significant investment capital needed in the private sector economy. but not large enough to create undue social problems? Comparatively, estates below $250,000 in value typically consist largely of personal assets, such as residences, household goods, personal effects, automobiles, and boats, and are woefully short of investment capital. Because of these differences in the nature of asset depending on estate size, our estate tax laws have tended in the aggregate to hit investment capital harder and personal assets easier. Exceptions in the income tax laws for residences indicate the same is true there to an extent. A nation wanting to be stronger economically would not disfavor investment capital, especially when there is a shortage of investment capital. The concern Congress expressed in 1976 about farms and their productivity for the nation should be expanded to include a concern for all productive investment capital, which our nation needs so much.

As we all know, the estate tax process is complicated and costly. Experts are required to plan an estate properly before it goes through the process and to administer one properly during the process. Moreover, the process requires IRS personnel and money. Does all this on balance contribute anything to the national good in the case of a $500,000 estate? None that I can see, and none according to most of my colleagues from coast to coast who make their living as the experts planning and administering estates.

For too long we have had estate and gift tax rates that tax too many estates too much, without regard to why they are being taxed at the assessed rate and whether the tax is falling too heavily on investment capital. The fundamental purposes of estate and gift taxes call for reduced rates at all levels except the highest, and they call for an increased unified credit.

4. *The outline of a basic proposal.*—(a) Rate reductions and a unified credit increase: Below, when discussing new rates specifically, I focus on estates below $5,000,000 in value. It has been necessary, however, to assume a top rate and a top amount for that purpose. The top rate and amount under the proposal have been left as they are now, 70 percent on amounts above $5,000,000.

This does not mean that the top rate and amount should be left as they are now, a subject not emphasized in this statement. Under the idea that a very large estate should be taxed very heavily, is a very large estate one in excess of $5,000,000, $10,000,000, or what? Obviously, this amount should be reconsidered from time to time as conditions and thinking change.

At least in the light of inflation, if not also in consideration of capital formation requirements, the top amount could be increased. If that is done, it could affect my proposed rates on amounts below $5,000,000. I should mention that my proposed rates on amounts below $5,000,000 would reduce taxes on the first $5,000,000 of a very large estate, but not on amounts above that.

At the other end of estate sizes, namely, the smaller taxable estates, the exemption equivalent of $175,625, produced by the $47,000 unified credit, should be at least doubled to $350,000. Inflation alone will soon require that. An increase to $500,000 would be justified because the fundamental purposes of estate and gift taxes simply do not make much sense today in the case of a $500,000 estate.

What should be done between $500,000 and $5,000,000? My suggestion is that rates above $500,000 start at a lower rate than today, say about 25 percent, and that they increase very modestly to about 35 percent until a certain estate size is reached, after which the rates would increase sharply as they move to 70 percent at the $500,000,000 level. What that certain estate size should be is difficult to determine, but it could be as much as $3,000,000 and should be at least $2,000,000. Those amounts sound large, I know; but we must keep in mind that a farmer with 500 acres of choice farmland free of debt worth $4,000 per acre has a $2,000,000 estate, not counting his machinery, livestock, insurance, and other property.

Originally, I intended to be much more vague or general in this statement as to the new rates. I have gone beyond that intention, but with the caveat that these proposals are very tentative and subject to the need for further testing and refinement. It may be that Congress should adopt rates even lower than those suggested, but the rates should not be higher than the general levels of those suggested.

(b) Revising and rethinking special use valuations: As discussed above, much of the need and pressure to liberalize section 2032A would be lessened by reducing estate tax rates and increasing the unified credit for all taxpayers. Any special problems which farmers and owners of other family businesses have remaining, in the light of those adjustments, should then be considered. That will involve sections 2032A, 6166, 6166A, 6601, 303, and possibly others.

In all events, section 2032A is in need of revision. It has numerous technical problems, some of which have been mentioned above. Additionally, it produces uneven results that call for other revisions and possibly some fundamental rethinking of the nature of the relief. For example, some have proposed that the relief under section 2032A should be transferred to section 6166 and there transformed from reduction of value to forgiveness of tax and interest installments, achieving basically the same result but with simpler laws and procedures.

All revisions and rethinking, however, should involve the entire package of relief provisions as to farms and other family businesses. Before exact answers can be reached, we need further analysis, as well as comment and proposals from the taxpayers with special problems and their organizations.

As a preliminary step toward that analysis, I have asked myself how much of the present relief afforded by section 2032A would be granted automatically by the proposed reduction of estate tax rates and the increased unified credit. In order to illustrate that, as well as certain other comparisons, I have prepared Appendix B. The first six columns do not allow for inflation since 1976. The next seven columns (7-13) attempt to allow for inflation during the seven years following 1976, under the same assumptions about inflation used in Appendix A.

From Appendix B, I draw a number of conclusions as to the relief that would be granted automatically by the proposed reduction of estate tax rates and the increased unified credit, with respect to farms and other family businesses and with respect to other properties.

If inflation since 1976 is disregarded, Column 5 shows that many estates with the maximum reduction of value under section 2032A, $500,000, would be benefited by the proposed rates and credits even if section 2032A is disregarded. Those that would not are those with values from slightly below $750,000 to slightly above $1,000,000. If inflation since 1976 is considered as in Appendix A, Column 12 of Appendix B shows that none of those estates would be benefited by the proposal, with those in that same range suffering the most in terms of percentages. The proposed rates and credit would grant automatically much of the relief now granted by a maximum use of section 2032A, but not all, especially if inflation is considered. Thus, if the same relief as to farms and other family business is to be continued, a need for relief in some form would continue, even under the proposed rates and credits. Appendix B uses the maximum reduction in value under section 2032A in all examples; at the lower end, where the severest problems arise, a maximum reduction will not in fact be available in many instances, and the relief under the proposed rates and credit may partially offset or even exceed the benefit of a lesser reduction in value, not only as to the farm or other family business but as to other properties.

In the case of estates not qualifying under section 2032A, Column 6 shows that the proposed rates and credit would result in substantial reductions in estate taxes; but if inflation is considered, Column 13 shows that the reductions in estate taxes would be much less and indeed modest, especially in the case of larger estates. The greatest reductions could be where they should be, among the smaller estates considered.

As noted above, whatever is to be done with the relief now afforded by section 2032A should be considered not only in the light of the proposed rates and credit, but also in the light of other changes discussed below.

(c) Merging and liberalizing the sections creating estate tax deferrals as a matter of right: For an estate to qualify for an estate tax deferral under section 6166, it must include an interest in a closely held business that exceeds 65 percent of the adjusted gross estate. For an estate to qualify for an estate tax deferral under section 6166A, it must include such an interest that exceeds only 35 percent of the value of the gross estate or 50 percent of the taxable estate. The payout is longer for the estate under section 6166, but qualification is easier for the estate under section 6166A.

As a reason for enacting section 6166 in 1976, a committee report includes these views:

"The present provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases, the executor is forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax. This may occur even when the estate qualifies for the 10-year extension provided for closely held businesses. In these cases, it may take several years before a business can regain sufficient financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners. Moreover, some businesses are not so profitable that they yield enough to pay both the estate tax and interest especially if the interest rate is high."

Even with the new section 6166, the deferral provisions are proving inadequate to deal with those liquidity problems, and they would continue to be inadequate, to a considerable extent, even under the relief proposed here as to rates and the unified credit. Additional relief that is badly needed could be granted by merging the two sections and generally by retaining the more liberal features of each. It may be highly advisable, additionally, to liberalize the merged section even more. For example, the fifteen-year payment period could be increased to twenty years.

(d) Amending the section regarding stock redemptions to pay death taxes: An important part of the special relief provisions as to farms and other family business is found in section 303. It provides in limited situations that a qualified redemption of stock to pay estate taxes and related items will be taxed as a capital gain, even though the redemption would have been treated under other sections as a dividend distribution and taxed as ordinary income.

Before the 1976 Tax Reform Act, one of the requirements for qualification under section 303 was that the value of the decedent's stock in the corporation included in his gross estate must constitute at least 35 percent of his gross estate or 50 percent his taxable estate. I am going to call this the "35 percent test." That same test was then the law under section 6166 for an estate tax deferral as a matter of right.

When the bill which became the 1976 Act first passed the House, the bill renumbered old section 6166 as 6166A, left it unchanged in substance, and inserted a new section 6166 providing for a payout more liberal than under section 6166A but calling for a much stricter test based upon 65 percent of the adjusted gross estate. That test I am going to call the "65 percent test."

Now to the point. That bill when it first passed the House changed the 35 percent test in section 303 to the much stricter 65 percent test. Why? The committee report says only that this change "appears desirable" and that it makes "this special capital gain treatment available only where the closely held business interest constitutes a substantial part of the estate. . . ." While severly clamping down on section 303, the bill left the 35 percent test for estate tax deferrals under section 6166A. The rhyme and reason for all this was obscure or non-existent. The Senate made no change in the bill as to section 303. When the bill reached the Committee of Conference, the light began to dawn, and the 65 percent test was changed to a 50 percent test, 50 percent being exactly halfway between 65 and 35 percent.

These changes in section 303 were not in order in 1976, and they are less in order now because of the special problems as to farms and other family businesses. Especially under the proposal that sections 6166 and 6166A be merged and that the more liberal features of each be used, including the 35 percent test of section 6166A, section 303 should be changed so as to have the 35 percent test.

(e) Liberalizing the rates of interest on estate tax deferrals: In 1976 Congress enacted section 6601(j) and limited the 4 percent per annum interest rate to the estate tax on the first $1,000,000 of farm or closely held business property provided it qualifies under section 6166. Qualification for a deferral under another section, not even section 6166A, will not produce this relief. The 4 percent rate cannot apply to an amount of tax greater than $345,800; and the maximum is almost always less than that. All other estate tax deferrals under various sections, as well as those under section 6166 in excess of the maximum allowed, were made to bear interest at the regular rate on deferred payments. That regular rate was 7 percent then. It is now 12 percent per annum.

As noted in the language last quoted, "some businesses are not so profitable that they yield enough to pay both the estate tax and interest especially if the interest rate is high." A rate of 12 percent per annum is high. It is extraordinarily high when compared with the 7 percent rate Congress had in mind in 1976. Even a rate of 4 percent per annum may be high in the case of a farm or other family business, especially when it produces a yearly profit before interest expense of only 2 percent of value and especially if reductions in value under section 2032A are not available.

In that same committee report, it is stated as follows:

"Allowing the reduced interest rate at a 4 percent level for a limited amount of tax is intended to reflect the problems that smaller businesses have in generating enough income and cash flow to pay interest at a normal rate and amortize the principal amount of the estate tax liability. It is felt that the 5-year deferral period plus the reduced interest rate on the tax attributable to the first $1 million in value of a closely held business should, in most cases, give the business time to generate sufficient funds to pay the estate tax and interest thereon without the business having to be sold to satisfy the estate tax liability (including a period for adjustment after the loss of one of the principal owners)."

That feeling mentioned may have been true in some cases in 1976, but it is true today in fewer and fewer cases.

I have not had a chance to develop specific proposals about interest rates, but it is crucial that they be liberalized generally. It may be necessary even to grant in limited situations a rate below 4 percent per annum.

The jump today from a 4 percent to a 12 percent rate is so high that many businesses simply cannot begin to make that olympian height. Would not it be wise to consider also a scale upward from 4 percent for the shorter jumpers, before the bar is set at 12 percent? Similarly, the plight of those not qualifying for a section 6166 deferral and facing a 12 percent rate as to the very first dollar of tax deferred under other sections should be considered. Some of those might be helped by being included within a liberalized section 6166 already proposed, and that is another reason for the proposal; but still there are some deserving of attention who never will be within section 6166.

Nor should we forget those taxpayers who are not entitled to a tax deferral under any section. Those needing to raise cash to pay estate taxes have always been able to consider the possibility of borrowing the money privately. The prime rate on those loans, recently set in excess of 18 percent per annum, precludes that possibility for many and forces a liquidation of substantial holdings at a time and price that may be most unfortunate. This problem argues both for lower interest as to those taxpayers and for reduced estate tax rates and an increased unified credit for all taxpayers.

(f) Increasing the gift tax annual exclusion: The annual exclusion for gifts has remained at $3,000 since 1942. If that amount was correct in 1942, it should be $10,000 or more now. If viewed anew, without regard to the 1942 amount, but in the light of the underlying reasons and needs today for the annual exclusion, it should be increased to $10,000 or more now. Viewed from any direction, the need for an increase is so obvious that one wonders why the increase was not included in the 1976 Act.

The necessity for a substantial annual exclusion has been undisputed through the years. In 1932, when the Sentate Finance Committee set the amount at $5,000, it said the exclusion "on the one hand, is to obviate the necessity of keeping an account of and reporting numerous small gifts, and, on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts."

There are other necessities for a substantial annual exclusion. Consider the millions of situations each year when taxpayers provide financial support to relatives and friends without any legal obligation to do so:

1. Transfers by an adult child to or for an aged parent to provide food, clothing, shelter, and basic amenities; and

2. Transfers by a parent to a young adult child to provide for college education or for an automobile or for getting married and starting a family.

Under the laws of most states, these transfers are gifts, because the transferor has no legal obligation to provide for those parents or young adults, as he or she has in the case of minor children. Although the Internal Revenue Service to my knowledge is not actively pursuing the taxpayers in this situation under the gift tax laws, most of my colleagues believe that these transfers are gifts under the federal gift tax laws as they are written, and we worry whether the Service is going to start pursuing taxpayers in this situation.

The recent changes of the age of majority from twenty-one years to eighteen years in most states have aggravated the problem. Inflation too has aggravated the problem. Take the college education of an eighteen year old as an example. The cost of that education for one year may be from $3,000 to $10,000. Christmas and birthday gifts and a gift of an automobile are to be included in the total for gift tax purposes. If the total is $5,000 during a year, a gift tax problem may be avoided automatically in a community property state by a husband and wife; but in all other states, gift tax returns must be filed to split the total in halves so as to bring each below $3,000. If the total is more than $6,000, say $9,000, there is going to be a taxable gift (or gifts) of at least $3,000 regardless of what is done. Up to certain limits, a gift tax payment can be avoided at the time because of the unified credit; but at death, the $3,000 taxable gift will be brought into the amount upon which the estate tax is calculated, resulting often in an estate tax on the $3,000, even though death occurs twenty years after the gift. The $3,000 subject to the estate tax may be split equally between the husband and wife or may be all in one estate, depending upon how the gift tax returns are completed.

Taxpayers simply do not understand that helping aged parents or young adult children may involve serious gift tax problems. Much less do they understand that Christmas, birthday, and wedding gifts may do so. It never occurs to them. It is unrealistic to think that it ever will.

Inflation since 1942 and a static exclusion of $3,000 have made many taxpayers lawbreakers. Keeping the annual exclusion at $3,000 will continue to make many taxpayers lawbreakers.

A word should also be said about the role of professional advisors in connection with the $3,000 exclusion. Most laymen have a very vague idea of how the gift tax operates. As previously pointed out, they clearly do not regard wedding gifts, Christmas gifts, and birthday gifts as transfers which have to be taken into account in computing total gifts for the calendar year. Nor, as indicated above, do they consider payment of college education expense as a gift. It is only when a professional advisor, such as a lawyer or accountant, advises them of the necessity to file a gift tax return that they become aware of this obligation. It is almost impossible, even if an effort is made, for professional advisors to police their clients' actions in this regard. Even more important is that conscientious taxpayers who seek professional advice are put at a disadvantage vis-a-vis the laymen who do not seek advice and never file gift tax returns and who thereby, in fact but not under law, preserve their unified credits intact. On the other hand, if taxpayers consult a professional and are told of the need to file gift tax returns to cover any amounts in excess of the $3,000 annual exclusion, many of them feel under an obligation to file the returns and use part of their unified credit. If the exclusion is substantially increased, the law would be more in conformity with what taxpayers believe it to be, massive violations of these kinds would be avoided, and those who conscientiouly obey the law would no longer be at such a disadvantage.

The amount of the exclusion creates another trap for the unwary, in that gifts made within three years of death are included in a decedent's estate if a gift tax return was required to be filed in connection with the gifts. This means that if a combination of college education expenses, birthday gifts, and Christmas gifts for a child are made by a parent within three years of death totalling more then $3,000, they come back into his estate, even the $3,000, as if they had not been made. In community property states where community property is being used to pay those expenses or make those gifts, then $6,000 is the measure; but in many cases, just the college education alone is going to exceed this. Of course, for donors in all other states, anything over $3,000 will cause a problem, because even if the spouse consents to have his or her $3,000 exclusion used in connection with a gift, a gift tax return must be filed. It is clear that Congress's intent in excluding from section 2035 treatment those gifts for which no return was required to be filed was to isolate and exempt those relatively small gifts which most people make from time to time. It was a "de minimus" rule. In 1980, gifts of at least $10,000 per donee should certainly be considered "de miniumus," and the annual exclusion should be raised accordingly.

5. *Keeping in mind some 1976 tax increases.*—Before leaving reductions of the estate and gift tax rates and increases of the unified credit and the gift tax annual exclusion, we should keep in mind the effect of the new unified transfer system adopted in 1976. That new system had the effect of substantially increasing for many taxpayers the total estate and gift taxes on their properties. This increase occurred even after giving allowance for two changes that benefited taxpayers: (1) the modest rate reductions throughout the schedule and (2) an increase in the exemption equivalent from $90,000 of exemptions for estate and gift taxes to the unified exemption equivalent of $175,625 effective in 1981 and thereafter.

The unified transfer system was designed to increase the total estate and gift taxes when a taxpayer makes taxable lifetime gifts and then wills the balance remaining after making the gifts and paying the gift taxes, so as to make that total approximate more closely what the estate tax would have been had he or she willed all the properties without having made any lifetime gifts. For many taxpayers, this had the effect of increasing the total taxes substantially, because this took away one of their opportunities to reduce taxes.

This change is not mentioned here to urge a repeal of the new unified transfer system or to question the reasons for the change. It is mentioned here, however, to suggest that this tax increase in 1976 should be kept in mind as one factor among many when we now consider reductions of the estate and gift tax rates and increases of the unified credit and the gift tax annual exclusion.

The 1976 increase for many taxpayers in the total estate and gift taxes on their properties, after allowing for the general rate reduction and the increased exemption equivalent, was as much as 36 percent in the illustrations included in Appendix C.

6. *An unlimited marital deduction.*—Just as most taxpayers do not realize that routine gifts to children may have gift tax problems, many do not realize that any gift to his or her spouse may have gift tax problems. When a husband has his stock registered in his name and his wife's name as joint tenants or tenants by the

entirety, a very common occurrence, he has a gift tax problem unless the gift is within the limits of the gift tax marital deduction and annual exclusion. Since many of those husbands understand neither the deduction nor the limits, they act without regard to the law, thinking that one ought to be able to make any gift to his wife or, in many cases, thinking she owns his property as much as he does and that a transfer is not a gift.

The reasons for an unlimited marital deduction, however, go far beyond taxpayer compliance. It is an idea espoused by many time to time, even by Professor Stanley Surrey in 1948 I am told. Many of my colleagues from coast to coast were never enthusiastic about the idea, because they considered it, strictly from a tax viewpoint, disadvantageous if used because of the stacking of properties in the surviving spouse's estate and the taxation there at higher rates. Recently, a number of factors have started to bear more strongly on the idea. Some of the factors are old, some new; some involve taxation concerns, some social concerns. Many people have recently concluded, and I am one, that the unlimited marital deduction is an idea whose time has come.

A compelling new factor is social. Because of a wife's inestimable contributions to the marriage between her and her husband, some financial, some of other kinds, but with her financial contributions often being indirect and without direct financial reward to her under law, the women of this country and many of the men are increasingly concluding that there should be under law a substantial sharing of the wealth of a marital partnership, as under community property laws. In Wisconsin, for example, a bill is pending to provide for sharing along those lines; and the pressure for laws of that kind is increasing and doubtless will continue to increase.

The opposition to new state laws along those lines is formidable. Recognizing that enactment may not be imminent in many states, these advocates are asserting that the federal tax laws should now be changed so as to permit tax-free transfers between spouses during marriage and at the death of a spouse. Many spouses want to make voluntary transfers so as to produce, in those marriages, substantial sharing. The estate and gift tax laws block those transfers for many by extracting tolls in the form of taxes on transfers. The idea is that if an unlimited marital deduction is enacted, individuals can effectuate sharing now, without having to await enactments in their states. Moreover, many husbands and wives believe, and have always believed, that properties generated by either during the marriage are truthfully and morally, if not legally, really "ours" and not "his or hers." An unlimited marital deduction would enable those people to give legal effect to their basic feeling of marital partnership and morality.

As to this special concern and any dispute about whether sharing should be the law, an unlimited marital deduction is neutral, for it would merely give to each spouse the option to share or not.

A change to make the tax laws conform with basic ideas of citizens about what those laws are and ought to be is an exciting opportunity. How would this idea fit with tax considerations?

The unlimited marital deduction should not lose revenue in the long run. In fact, when it is used, it may increase revenue in the long run because of estate-stacking. Over the near term there may be a revenue loss to the extent it is used; but not everyone by any means would use it because of the estate-stacking and other problems.

It would offer another relief that could be used by owners of farms and other family businesses. If the owner dies first, he or she could completely defer all estate tax problems by willing all properties or substantially all to the surviving spouse. Some may elect to do that, in effect buying time, even though the problems may be worse when the second spouse dies. Whether to do that or not is an election that can be given properly to the ones most directly involved. After all, the primary consideration may be to keep the surviving spouse in business, not the children.

Perhaps the most exciting feature is the simplification of the tax laws that would result. Already, as a result of the 1978 Act, we have in the law a small step toward recognition of sharing that is very complex, namely, a reduction in value of joint interest property under section 2040 where the surviving spouse has materially participated in a farm or other family business. Another such step is now pending before Congress, in the form of reductions in value under a new section 2040A where the spouse has materially participated. These steps are complex and can be avoided simply and easily, with respect to the surviving spouse, by an unlimited marital deduction.

Simplification continues on and on. Obviously, many of the complications of the marital deduction sections, 2056 and 2523, both for estate and gift tax purposes, would be solved automatically. Drafting wills and trust agreements would be vastly simplified by the stroke of a legislative pen. The joint interest estate tax provision, section 2040, is still a mess, after efforts to improve it in 1976 and 1978. All of those problems between husband and wife, who own a vast majority of the joint interests involved, would be solved automatically. Some of the most difficult problems we face today involve transfers between spouses, during life and at death, of life insurance and employee benefits. They include not only problems under sections 2042, 2039, and 2035, but also those under gift tax sections, all of which are solvable automatically.

Free transferability between husband and wife: its time has come!

7. Additional proposals.—(a) Revising or repealing the orphan's deduction: A laudatory idea the orphan's deduction, it is a mess in application because of its provisions and is, I fear, costing the taxpayers far more now in legal expense and trouble than the value of the relief the orphans of this nation will receive in the future.

To explain this harsh verdict, I mention only two of the problems. The first is that the extremely complex terminable interest rules developed for the marital deduction are made generally applicable to the orphan's deduction. Using those rules on the orphan's deduction, which is so small and scarce in reality, is like using our most sophisticated missile on a rare bird. In 1978 Congress created an alternative to these rules, the qualified minor's trust, the complexities of which are now undetermined in extent because not even the experts can agree on how to create one of these trusts.

One might say, since the orphaning of children is rare, that these complexities ought to arise and be encountered rarely. The second problem I mentioned is that that is not so: these complexities must be encountered and contended with frequently, even though children are seldom orphaned. Whenever a lawyer is preparing a will for a parent with a minor child, a common occurrence, the lawyer must explain to the parent the orphan's deduction to determine whether the parents wants to use it. The lawyer is uncertain in explaining and the parent in understanding. If the answer is yes, then the lawyer must wrestle with the complexities and try to provide for the deduction, with special provisions of great length and complexity, often disposing of properties irrationally in order to comply with the statute, section 2057. The problem is that all of this costs the parent more legal expense now when the will is prepared, in order to provide or not to provide for an event that is very unlikely to occur. Often the parent has a relatively modest estate and should not have to spend money in this way.

If the orphan's deduction is to be retained, section 2057 should be amended to provide for the deduction automatically if there is any orphan, regardless of the disposition of the parent's property. The possibility that the parent's property is not going to his or her orphaned child, at least to the extent of the amount of the deduction, surely must be less than one in a million.

If the orphan's deduction cannot be made that simple, it should, in my judgment, be repealed.

The present situation is more bizarre than most of Lewis Carroll's.

(b) *Amending the disclaimer provision:* The disclaimer provision, section 2518, is also in disarray, I hate to report. An explanation of the problems is necessary in order to see the answers.

Before the 1976 Act, the federal disclaimer laws generally were dependent on applicable state law: if the disclaimer was valid under state law, it was usually valid for federal tax purposes; and the converse was true. This relationship worked reasonably well, but far from perfectly.

One problem was that state laws varied from state to state, producing a not completely uniform result under federal law. A classic example was the *Hardenbergh* case, where an intestate heir could not validly disclaim under Minnesota law (many other states provide the contrary) and hence could not do so for federal tax purposes.

Another problem was that the Internal Revenue Service occasionally disagreed as to whether a feature of state law was reasonable and proper and tried to prevent its application for federal tax purposes. A classic example was the *Keinath* case, where a husband left his property for his wife and then on her death to his son if living. The wife died nineteen years later, whereupon the son disclaimed within a short time after his mother's death when the bequest to him became fixed in nature and amount. This disclaimer was valid under state law and was held to be so under federal law, over the Service's objection that nineteen was too long.

A 1976 committee report states that a purpose of section 2518 was to achieve "uniform treatment" and a "uniform standard" for determining the time within which a disclaimer must be made. This the new section did not achieve at all. An unstated purpose apparently was to overrule the *Keinath* case prospectively. This new section did most certainly.

What else did the drafters of section 2518 do? Whoever they were, they created a sketchy federal law of disclaimers and made disclaimers, for federal tax purposes, dependent not only on the new federal but on applicable state law as in the past. Thus, instead of having a single test for disclaimers, as in the past, we now have two tests, both of which must be passed. It is obvious that the variations among state laws are still with us. The problem was noted to some extent in a 1976 committee report. It was observed that if the federal requirements are satisfied, a refusal to accept is to be given effect for federal tax purposes even if the applicable local law does not technically characterize the refusal as a disclaimer. In that connection, the Service has recently ruled that a disclaimer within nine months as permitted by federal law is not valid because it was not within six months as required by applicable state law. The Service is at fault there, but the statute is at greater fault.

What else did those drafters of section 2518 do? They either ignored or considered and rejected some fine proposals available then. One was adopted by the American Bar Association in 1974. Another was proposed in principle as part of the American Law Institute estate and gift tax recommendations adopted in 1968. Both proposals are cited in a footnote to a 1976 committee report. These two proposals are described favorably by Thomas W. Wiley of Phoenix in a paper prepared by him recently, which is included as Appendix D with his permission.

The problems with section 2518 extend deeply into the substance of the new federal law of disclaimers. It is inadequate and poorly conceived. What kinds of partial disclaimers are permitted is one uncertainty among many.

In connection with any revision of the section, the absolute nature of the nine-month rule must be reconsidered carefully. The rule now is the disclaimer must be made no later than nine months after "the date on which the transfer creating the interest in such person is made," for example, within nine months after a taxable transfer such as the testator's death or the creation of an irrevocable trust. Part of the rule is that the only exception occurs in the case of a disclaimant under twenty-one years of age. Frequently a person who may wish to disclaim never learns in time to disclaim that he or she is named in a will. The will may not have even surfaced for nine months. Consider this example. A wills property to B for life, then to C outright, but B can appoint the property to anyone in the world except B. More that nine months after A's death, B appoints to X, who has never heard of any of this before. Under the nine-month rule, it is too late for X to disclaim.

Consider a much more common example. A husband wills everything to his wife for life, then to his children outright. Under the nine-month rule, his children, if they are over twenty-one years old, have to decide and act within nine months of their father's death if they wish to disclaim. Often a rational decision is impossible to make then, because the children do not know, respectively, when the property will come to them (that is, when their mother will die), how much value the property will have then (that is, how much their mother will have needed and how much what remains will have gone up or down in value), what the properties will be then (that is, whether there will still be properties in which the children have special interests), and how much wealth and health the children will have then. But decide they must, under the nine-month rule. This example is, of course, the *Keinath* case. The court found that it was reasonable if the child disclaimed within a few months after the mother's death, when all these questions became answerable, provided, of course, the child had received no benefits before. Congress overruled that decision in 1976, as well as all other disclaimer possibilities not within the nine-month rule.

There is a problem here involving the *Keinath* case and the nine-month rule, as to which people have differed. If the *Keinath* result is wrong, then the nine-month rule is wrong, at least as wrong, and I say a great deal more wrong.

When the tax technicals want to overrule a specific case, it would be nice if they confined themselves. When they wanted to overrule the *Byrum* case in 1976 (involving section 2036), they messed up much more. When they wanted to overrule the *Keinath* case in 1976, they messed up much more. It would be nice if someone took away their blunderbusses and issued them small bore rifles along with safety instructions and common sense. A lot people in this country are getting tired of having to reconstruct the good that some tax technicians shoot away with their blunderbusses.

Specifically, what is wrong on balance with a rule that a disclaimer is all right if made within nine months after the time of a taxable transfer or the time when a disclaimant's interest becomes fixed and certain, whichever is later? I hope Congress will consider this question. It is not an easy one, but I say the answer on balance is nothing.

(c) Statute of limitations considerations: Under present law taxpayers face great uncertainty with respect to when, if ever, they can be assured that the Internal Revenue Service will not challenge valuations of transfers made during life and the computation of taxes with respect to them. If a gift tax return is filed in connection with a transfer, the statute of limitations with respect to transfers made during the period covered by the return runs at the end of three years from the date the return is filed; or, if values on the return are found to be understated by more than 25 percent, there is a six-year statute of limitations. However, if no tax is paid in connection with the transfer, the Internal Revenue Service is free, in effect, at any time to reopen that closed year by asserting in a subsequent year with respect to which the statute has not run that, by reason of undervaluation of prior gifts, transfers for that open year are to be taxed in a higher bracket than was reported by the taxpayer. That is the effect of any cumulative tax which takes into consideration prior gifts in determining rates.

In order to insure that the Internal Revenue Service is foreclosed, within either the three- or six-year period, from raising the valuation issue, a tax has to be paid. However, the Internal Revenue Service has, both in public and private rulings, taken the position that no taxes can be paid until the unified credit is completely consumed. Its use is mandatory, not elective, as was the case with the former $30,000 gift tax exemption. Taxpayers cannot even choose to waive (and hence lose) part of the unified credit in order to pay a tax to commence the running of the statute. There is no reason why use of the unified credit should be mandatory, with the result of placing taxpayers in the untenable position of having to make substantial gifts before there is any certainty with respect to valuation.

Even if the unified credit is used up and tax paid, present law does not make it clear that values as reported on the gift tax return cannot be reopened for estate tax purposes or, for that matter, in connection with the determination of a generation-skipping transfer tax. Therefore, not only should the use of the unified credit be made discretionary, but any mechanism for the final running of a statute of limitations with respect to valuation on inter vivos transfers should clearly foreclose the IRS from arguing about valuation with respect to the estate or gift tax or the generation-skipping transfer tax. Before the gift and estate taxes were unified and before there was a generation-skipping transfer tax, this potential estate tax problem did not exist when the statute had run as to a gift, because the gift had no bearing on the estate tax. It is not clear, with the unified transfer tax and the generation-skipping transfer tax, that this is now the case.

(d) Transfers within three years of death: In view of unification of the estate gift taxes, which results in "counting" all taxable transfers made during life in computing the estate tax, does it make any sense to retain subsections (a) and (b) of section 2035? The section includes in a decedent's estate, at federal estate tax values, all transfers made within three years of death, except those made during that period for which no gift tax return was required to be filed. All that subsections (a) and (b) now accomplish is to reflect, for estate tax purpose, any appreciation or depreciation in value that might have occurred between the date of the transfer and the date for estate tax valuation. Would it not be sufficient merely to gross up, and include in the decedent's estate, any gift taxes paid on account of transfers within three years of death? That is, subsection (c) could be left. The insurance provision now contained in section 2035(b), if wanted, could be moved to section 2042. This would place the decedent's estate in the same position as it would have been had the transfers not been made and had no gift tax on them been paid, except for any appreciation or depreciation that might have occurred during that period. It would simplify the law and would make the 1976 changes in section 2035 more palatable to taxpayers, with only a minor change in the substance of the present law. The whole concept of unification was to have taxable inter vivos transfers included in the ultimate estate tax basis. Now that that is accomplished, subsections (a) and (b) of section 2035 really are no longer needed and are a needless complexity in the tax laws.

(e) The generation-skipping transfer tax: Few people realize that we have under Chapter 13 a completely new tax, the generation-skipping transfer tax, which should be added to the list of the income tax, the estate tax, and the gift tax. At times since 1976, I have thought that the most serious defects in the 1976 Act could lie in Chapter 13, except, of course, the defects in carryover basis. The problems under Chapter 13 have not yet started occurring; and for that reason alone, they are, candidly, not pressing today.

When I say they have not yet started, I mean that events are not occurring which trigger the tax often. The problems, however, are occurring in great frequency in the planning stage when wills or trust agreements are prepared.

The press of time in preparing this statement prevents me from addressing the problems. Let me see if I can use a short cut. Shortly after the 1976 Act was enacted, Richard B. Covey of New York City issued a book with 152 pages of text explaining the new generation-skipping transfer tax and noting numerous problems and uncertainties. Today, that book is in its third edition with a supplement, containing 325 pages and 36 pages of text respectively. I mention this as an indication of the massive problems that must be faced before too long.

Let me also mention one problem among many that surely will concern Congress. When this new tax was passed, Congress obviously did not intent to involve smaller estates. Accordingly, it included a $250,000 grandchild exclusion for that purpose. It is not, however, working in many, many instances where it was intended to work.

The grandchild exclusion was intended to work this way. If one wills property to his two children for life and then to each child's children, the generation-skipping transfer that occurs upon each child's death is softened or eliminated by the $250,000 exclusion upon each child's death as to properties passing to the child's children (grandchildren of the testator). Potentially, a maximum of $500,000 could be excluded, $250,000 as to each child.

Frequently, in that situation, the properties are not left to the grandchildren outright, but are left in a non-vested trust for one or more of them. If that is done, the $250,000 grandchild exclusion is not available. If the child's taxable estate and adjusted taxable gifts and the child's trust total in value more than $175,625, anything in the trust passing to a grandchild in a non-vested interest trust will trigger the new tax and the new tax process. If a vested trust for the grandchild is used, the exclusion will be available, but thousands of wills are being drawn without this technicality in mind.

This problem resulting from the vested interest requirement arises in another situation even more frequently. Suppose one wills property in trust for his children to age thirty, for example, and provides that if any child dies before that age leaving children, his or her share will pass to his or her children. The will provides similarly for a non-vested trust to age thirty for grandchildren. This kind of will is typical for modest estates in many parts of the country. If the child dies before age thirty leaving children, a generation-skipping transfer will have occurred, and no grandchildren exclusion will be available.

Would it make much difference to the Treasury if the vested interest requirement is relaxed, so that any of the commonly used trust arrangements for grandchildren designed to terminate before death will be all right? It would make a lot of difference throughout the nation among a lot of taxpayers for years to come.

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APPENDIX A

How Inflation Increases Estate Taxes

1*	2**	3	4*	5**	6	7	8
Estate Size 1/1/77	Estate Tax 1/1/77	Percentage of Estate Payable as Tax 1/1/77	Estate Size (Col. 1 doubled)	Estate Tax 1/1/84	Percentage of Estate Payable as Tax 1/1/84	Estate Tax 1/1/84 in 1977 Dollars (Col. 5 halved)	Percentage Increase in Tax Using 1977 Dollars (Increase from Col. 2 vs. Col. 7)
$ 2,500,000	$ 978,800	39%	$ 5,000,000	$ 2,503,800	50%	$ 1,251,900	28%
2,000,000	733,800	37%	4,000,000	1,833,800	46%	916,900	25%
1,500,000	508,800	34%	3,000,000	1,243,800	41%	621,900	22%
1,250,000	401,300	32%	2,500,000	978,800	39%	489,400	22%
1,000,000	298,800	30%	2,000,000	733,800	37%	366,900	23%
750,000	201,300	27%	1,500,000	508,800	34%	254,400	26%
500,000	108,800	22%	1,000,000	298,800	30%	149,400	37%
250,000	23,800	10%	500,000	108,800	22%	54,400	129%

* Taxable estate plus adjusted taxable gifts.

** A unified credit of $47,000 is used in calculating the taxes in Cols. 2 and 5, without allowance for any other credit

Appendix C

This Appendix is designed to illustrate how the unified transfer system adopted in 1976 has increased the total estate and gift taxes for many taxpayers, after allowing for the reduction in rates and the increase of the exemption equivalent in 1976.

It is assumed here that a taxpayer made a lifetime gift of half his properties more than three years before his death and that he willed the other half, less his gift tax, at his death. Net amounts after deductions are used. It is also assumed that no gift tax annual exclusion was available as to the gift.

If the taxpayer had properties with a value of $2,500,000, his gift would have been $1,250,000. Under the law before 1977, his gift tax would have been calculated on $1,220,000 ($1,250,000 less the gift tax exemption of $30,000) and would have been $317,400; his estate tax would have been calculated on $872,600 ($1,250,000 less the gift tax less the $60,000 exemption) and would have been $278,562; total taxes would have been $595,962. Under the law in 1981 and thereafter when the unified credit has peaked at $47,000, his gift tax would be calculated on $1,250,000 and would be $401,300 ($448,300 less $47,000); has estate tax would be calculated on $2,098,700 and would be $380,863 ($829,163 less the gift tax less $47,000); total taxes would be $782,163, which would be a 31 percent increase over total taxes previously of $595,962.

If the taxpayer had properties with a value of $5,000,000, his gift would have been $2,500,000. Under the law before 1977, his gift tax would have been calculated on $2,470,000 ($2,500,000 less the gift tax exemption of $30,000) and would have been $737,625; his estate tax would have been calculated on $1,702,375 ($2,500,000 less the gift tax less the $60,000 exemption) and would have been $619,269; total taxes would have been $1,356,894. Under the law in 1981 and thereafter when the unified credit has peaked at $47,000, his gift tax would be calculated on $2,500,000 and would be $978,800 ($1,025,800 less $47,000); his estate tax would be calculated on $4,021,200 and would be $868,780 ($1,894,580 less the gift tax less $47,000); total taxes would be $1,847,580, which would be a 36 percent increase over total taxes previously of $1,356,894.

If the taxpayer had properties with a value of $10,000,000, his gift would have been $5,000,000. Under the law before 1977, his gift tax would have been calculated on $4,970,000 ($5,000,000 less the gift tax exemption of $30,000) and would have been $1,836,975; his estate tax would have been calculated on $3,103,025 ($5,000,000 less the gift tax less the $60,000 exemption) and would have been $1,320,894; total taxes would have been $3,157,869. Under the law in 1981 and thereafter when the unified credit has peaked at $47,000, his gift tax would be calculated on $5,000,000 and would be $2,503,800 ($2,550,800 less $47,000); his estate tax would be calculated on $7,496,200 and would be $1,747,340 ($4,298,140 less the gift tax less $47,000); total taxes taxes would be $4,251,140, which would be a 35 percent increase over total taxes previously of $3,157,869.

[Appendix D]

American College of Probate Counsel, Midyear Meeting 1980

DISCLAIMERS: A NEED FOR MORE REFORM

(By Thomas W. Wiley)

This article will focus on history, policy and the need for reform in the area of disclaimers. It will begin with a brief resume of the law prior to the Tax Reform Act of 1976 ("'76 Act") and then summarize the effects of the '76 Act and its numerous problems. Next the major possible alternatives to existing law will be outlined along with a discussion of the author's personal preference.

EVOLUTION OF PRESENT LAW

Disclaimers (or renunciations as they are interchangeably called) are not new. As a property law concept they were recognized long ago as part of the English common law.[1] As a gift and estate tax concept, they have also been recognized and have been accepted by the courts and the government as a valid means of preventing gift or estate taxation under a variety of ciricumstances.[2]

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[1] See Uniform Probate Code, Comment to Subsection (a), § 2-801.

[2] See Generally L. Newman & A. Kalter, Postmortem Estate Planning, ALI-ABA 1976 [hereinafter cited as Newman-Kalter]; Martin, Perspectives on Federal Disclaimer Legislation, 46 U. Chi. L. Rev. 316 (1979) [hereinafter cited as Martin].

Prior to the '76 Act the federal tax provisions were scattered about in the Internal Revenue Code and Regulations.[3] And while the provisions were vague and incomplete in many respects, they clearly allowed disclaimers of many property interests for both gift and estate tax purposes.[4] The validity of a disclaimer depended for the most part on its validity under state law.[5]

The Code and Regulations expressly recognized disclaimers for several specialized estate tax purposes. E.g., if a disclaimed interest passed by the terms of the trust or will or by operation of law to a surviving spouse, it could qualify for the marital deduction.[6] If a disclaimed interest passed by the terms of a trust or will or by operation of law to a charity, it could qualify for an estate tax charitable deduction.[7] The Code and Regulations under § 2041 expressly permitted the disclaimer of a general power of appointment.[8]

According to the Regulations,[9] there were two principal requirements for a valid disclaimer. One was that it be made within a reasonable time after the transfer and the other was that it be valid under state law. The problems arose out of conflicts between state and federal law and the lack of uniformity among the state laws. The following are two illustrative, but by no means exhaustive, examples of federal and state law conflicts under the prior law.

In most states under common law or by statute a disclaimer of an interest passing under a will is valid, whereas in the absence of a statute, a disclaimer of an intestate share usually is not valid.[10] In *Hardenbergh* v. *Commissioner*,[11] the court upheld the requirement of the Regulations that the disclaimer must be valid for state law purposes to qualify for federal gift tax purposes. Under the applicable Minnesota law which did not have a statute allowing disclaimer of an intestate share the intestate share was deemed to vest automatically in the heir and an attempted disclaimer of the share was, therefore, not valid for tax purposes. That result was not necessarily wrong but from a tax policy standpoint it was undesirable, since people identically situated in substance would be differently treated depending upon whether or not the state had a statute permitting disclaimer of an intestate interest.

Another example of the conflict between state and federal law arose in *Keinath* v. *Commissioner*.[12] There, a trust under a will provided income for a surviving wife for life, remainder to a son if living and if not to his issue. The wife died 19 years later. Within 6 months after that the son disclaimed his remainder interest. The disclaimer after the death of the wife was valid under state law. Despite that, the government contended the disclaimer was not valid for federal tax purposes since the "reasonable time" for disclaiming ran from the date of death of the father who created the trust and not from the death of his wife who was life income beneficiary. The Tax Court agreed with the government. The Eighth Circuit, however, reversed and held for the taxpayer, saying that the state law rule was reasonable and should control in determining the time within which to make the disclaimer.

TAX REFORM ACT OF 1976

Shortly after the decision in *Keinath* the 1976 Act was adopted. The disclaimer provisions are primarily found in new Code Section 2518[13] relating to gift taxes;

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[3] See Martin, supra note 2, at 321 n.18. See generally ABA Tax Section Recommendation No. 1974-2, 27 Tax Law. 818 (1974).

[4] See Martin, supra note 2, at 321 n.21, 316 n.3.

[5] See generally H.R. Rep. No. 94-1380, 94th Cong., 2nd Sess. 66 (1976), 1976-3 C.B. 800; J. McCord, 1976 Estate and Gift Tax Reform (1977); Frimmer, Disclaimers After the Tax Reform Act of 1976: Chaos Out of Disorder, 31 U.S. Cal. L. Center Tax Inst. 811, 814 n.17 [hereinafter cited as Frimmer, Chaos].

[6] I.R.C. § 2056(d)(2)(A) (repealed by the Tax Reform Act of 1976).

[7] I.R.C. § 2055(A).

[8] Treas. Reg. § 20.2041-3(d)(6).

[9] Treas. Reg. § 25.2514-3(c)(5) (1958); Treas. Reg. § 25.2511-1(c) (1958); Treas. Reg. § 20.2041-3(d)(6) (1942).

[10] See generally Uniform Probate Code, Comments, § 2-801; Newman-Kalter, supra n.2 at 11; Martin, supra n.2, at 318; Frimmer, Disclaimers and Elections 109, 116 (Outline presented at P.L.I. Program, 1979).

[11] 17 T.C. 166 (1951, aff'd.), 198 F.2d 63 (8th Cir. 1952), cert. denied 344 U.S. 836 (1952).

[12] 58 T.C. 352 (1972), rev'd, 480 F.2d 57 (8th Cir. 1973).

[13] (a) General rule.—For purposes of this subtitle, if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.

(b) Qualified disclaimer defined.—For purposes of subsection (a), the term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property but only if—(1) such refusal is in writing, (2) such writing is received by the transferor of the

Footnotes continued on next page

they are incorporated by reference into new Code Section 2045[14] relating to estate taxes. Section 2518 spells out in considerably more detail than did the previous regulations, the requirements for a valid disclaimer. The Committee Reports state that the purpose of the legislation was to achieve uniformity in the application of the tax law to disclaimers.[15] That this was the goal is not apparent from examining the result. If it was, it surely was not attained. One suspects, perhaps a bit cynically, that the main object of the legislation was to reverse the rule in the *Keinath* case, which is did very explicitly. In that respect, uniformity was obtained. In most other important respects it was not.

INADEQUACY OF THE 1976 ACT

A few examples will show how inadequate the 1976 Act was and point up the conflict of laws problems it created or left unresolved:

1. Under new Section 2518 there is a qualified disclaimer only if "as a result of the disclaimer the interest passes to a person other than the disclaimant without any direction on the part of the disclaimant." This "pass to" requirement throws the matter right back to state law, because if the disclaimer is not valid under state law, the property does not "pass to" someone else without directions by the disclaimant. As you may recall, the 1978 Act modified or clarified one aspect of this "pass to" requirement by stating expressly that if the surviving spouse is the disclaimant, the property may nevertheless pass to the surviving spouse.[16] This covers the case where the surviving spouse disclaims—for example, all or part of a marital deduction gift—and the interest falls into a residuary trust under which she has an income interest. Under most state laws a disclaimer of this type would presumbly be valid regardless of who makes it.[17] Now, under federal tax law, if appears to be valid only if made by a spouse.

2. Under the new law, the *Hardenbergh* problem is not solved, it is not even addressed. A disclaimant may comply with all of the rules for a qualified disclaimer as set out in § 2518, but under some state laws, an interstate interest still cannot be validly disclaimed.[18] Therefore, it will not "pass to" someone other than the disclaimant without any direction on the part of the disclaimant and so will not qualify for federal purposes.

3. To have a qualified disclaimer under the new Act there must be an unqualified refusal to accept the interest and three technical requirements in addition to the "pass to" requirement, must be met:

(a) It must be in writing.[19]

(b) The writing must be delievered to the transferor of the interest or his legal representative or the legal title holder of the interest not later than 9 months after the later of (i) the day on which the transfer creating the interest in the disclaimant is made, or (ii) the day on which the disclaimant attains 21.[20]

Footnotes continued from last page
interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of—(A) the date on which the transfer creating the interest in such person is made, or (B) the day on which such person attains age 21, (3) such person has not accepted the interest or any of its benefits, and (4) as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—(A) to the spouse of the decent, or (B) to a person other than the person making the disclaimer.

(c) Other rules.—For purposes of subsection (a)—(1) Disclaimer of undivided portion of interest.—A disclaimer with respect to an undivided portion of an interest which meets the requirements of the preceding sentence shall be treated as a qualified disclaimer of such portion of the interest. (2) Powers.—A power with respect to property shall be treated as an interest in such property."

[14] "For provisions relating to the effect of a qualified disclaimer for purposes of this chapter, see section 2518."

[15] H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. (1976); H.R. Rep. No. 94-1515, 94th Cong., 2d Sess. (1976).

[16] Revenue Act of 1978, P.L. 95-600, § 702(m)(1), 92 Stat. 2935 (1978) (amending I.R.C. § 2518(b)). See generally Audy & Duhl, Revenue Act of 1978 Brings Major Changes in Estate and Trust Planning, 50 Journal of Trxation 84, 88, (1979).

[17] See generally McCue, Disclaiminers: A Survey of I.R.C. Section 2518 And the Illinois Disclaimer Statute, 1978 U. Ill. L.F. 395, 402-03; 11-8th Tax Mngm't (BNA), Estates, Gifts, and Trusts-Planning, A-136-38, (1979).

[18] See generally Hardenbergh v. Commissioner, 198 F. 2d 63; I.R.S. Private Letter Ruling Nos. 7821045, 7820022, 7803065; Frimmer, Using Disclainers in Post Mortem Estate Planning: 1976 Law Leaves Unresolved Issues, 48 Journal of Taxation 322, 323 (1978); Martin, supra note 2, at 323-26; Frimmer, Chaos, supra note 5, at 818-24.

[19] I.R.C. § 2518(b)(1).

[20] I.R.C. § 2518(b)(2).

(c) The disclaimant must not accept the interest or any benefit under it.[28]

(d) Section 2518 apparently provides that the disclaimer must be made within the prescribed time even though the person involved has no knowledge of the interest that may be disclaimed. The Uniform Acts[29] and most state laws allow a disclaimer within the prescribed time after the person entitled to disclaim has actual knowledge of the interest.

(e) Most state laws deal adequately and appropriately with such items as powers of appointment, joint tenancies and partial disclaimers. On these subjects, Section 2518 is woefully inadequate, and also appears to be in conflict with many aspects of the state laws.[30] The Regulations when we get them may help but probably not much.

ALTERNATIVES FOR REFORM

In view of all this, it seems obvious that the new federal disclaimer rules were not well thought out, were not coordinated at all with the general trend of state law and actually created more problems than they solved. Most people would agree that the present situation is not acceptable. The question is what should be done. The following are four possible solutions.

1. Exclusive reference to State law.—One alternative would be to look exclusively to state law to determine whether there has been a valid disclaimer, and if there has, treat it as valid for federal gift and estate tax purposes. The late Austin Fleming, who was a reporter for the Uniform Disclaimer Acts, was an advocate of this position. His view and the view of many others working on state legislation was that if the states adopted well-conceived and reasonably uniform laws, the federal law should simply make reference to them in determining what is a qualified disclaimer. This approach has a great deal of merit. Most states now have disclaimer statutes and while there are differences in wording there do not appear to be very many differences in substantive result.

Looking solely to state law however, is probably not politically feasible. It would in theory at least allow states to adopt disclaimer rules which could be considered abusive when applied to tax questions. And what is abusive is a matter of opinion. Witness the *Keinath* case. What the 8th Circuit thought was a perfectly reasonable state law rule, the tax writers of the '76 Act thought was out of line and had to be reversed. While the exclusive reference to state law is alluring, the trend is the other way, and it is difficult to believe that the Treasury or the Congress would accede to this solution.

2. American Bar Association's proposal.—The second alternative is one which was proposed by the Section of Taxation and adopted by the American Bar Association in 1974.[31] It was made available to the tax writers of the '76 Act and was either considered and rejected or ignored. That proposal advocated the adoption of new Code Sections 2518 and 2045. However, unlike the '76 Act, the ABA's proposal contained all of the details necessary to make a comprehensive and coherent federal disclaimer statute. Many of the concepts and some of the language from the Uniform Disclaimer Acts were incorporated. This ABA version would have had the virtue of bringing the federal law very close in line with the state laws that had then and have since been enacted.

In addition, it provided a mechanism for solving the problem that arises when state law is not as liberal about disclaimers as is the federal law. The classic case is *Hardenbergh,* described earlier, on disclaimer of an intestate interest. The A.B.A. proposed federal rule would have allowed such a disclaimer.[32] However, under some state laws it is still invalid since the intestate interest vests immediately and directly in the heir. To solve that problem the A.B.A. proposal would have allowed the disclaimant to make an appropriate transfer by deed or assignment to the taker who would have been entitled if a disclaimer under state law had been valid.[33] Under the proposal, the disclaimant could not accept a benefit or assert any other dominion or control over the interest, except to perform the ministerial act necessary to put title in the proper place.

The ministerial act provision would also solve the problem where the state law requires the disclaimer within six months or perhaps less, while the federal law allows nine.[34] If a disclaimer is made after the six months but before the end of

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[28] I.R.C. § 2518(b)(3); See also Private Letter Ruling No. 7808078.

[29] See e.g., Uniform Disclaimers of Property Interests Act § 2(b).

[30] See generally Frimmer, Chaos, supra note 5.

[31] ABA Tax Section Recommendation, supra note 3, at 818.

[32] Id. at 819.

[33] Id.

[34] Id. See also Martin, supra note 2, at 353.

nine, it would still be valid for tax purposes if the disclaimant by deed or assignment causes title to pass to the proper person.

This approach by the A.B.A.—a comprehensive federal statute coupled with a ministerial act provision to achieve uniform treatment in all states—seems to me to be quite workable. Several years of effort went into the preparation of that proposal and while it may not have solved all the conceivable problems it would have been substantially better than what was finally adopted in 1976.

3. Taxation of disclaimers.—A third alternative which would be a radical departure from past and present law, would be to tax disclaimers just as though they were taxable general powers of appointment. This has been suggested in an interesting and well-reasoned article in the University of Chicago Law Review by Professor John H. Martin.[35] Professor Martin argues that disclaimed property should be a part of the transfer tax base because the disclaimant has the power either to take the property as his own (analogous to a general power) or to allow it to pass to someone else (analogous to the lapse of a general power).

Professor Martin's article will repay reading, but, with all due respect, his solution is unsatisfactory. It is true that the disclaimant has an option in the first instance to take the property or interest in property as his own which makes it similar in that respect to a general power. On the other hand it seems unfair to impose a transfer tax upon a person who has never accepted or benefitted in any way from the power or the property interest disclaimed and is unwilling to do so. The key to the distinction is that a disclaimant must promptly disavow any rights he may have; whereas the holder of a general power taxable under current law may hold the power over a long period of time. During that time he benefits from keeping his options open and being able to consider carefully whether or not to exercise the power and if so, how.

Also, taxation of a disclaimer would involve imposition of a rapid-fire double tax. There would first be a transfer tax upon the donor or the decedent's estate that created the interest. Then within nine months there would be a second tax imposed on the donee-disclaimant or his estate. If a credit is allowed for the prior transfer tax, it would defeat the purpose of taxing the disclaimer. But if no credit is allowed, there is, it seems to me, a very inequitable double tax.

Furthermore, taxing disclaimers would not simplify the law. It would merely substitute a whole new set of very complex substantive and procedural problems for those we now have. Exceptions to the general rule would need to be carved out. For example, it is doubtful whether anyone would want to tax the disclaimer of special powers, or administrative powers. It would be terribly complex to draw the line. Professor Martin would allow the tax on the disclaimer to be collected from the disclaimed property, but the transfer would be attributed to the disclaimant and the amount of the tax based on the disclaimant's transfer tax rate. That concept is not new, but its application here would be very complicated.

All in all, taxation of disclaimers is not an appropriate solution.

4. American Law Institute Proposal.—There is a fourth alternative which seems to provide the most satisfactory solution. It was proposed in principle as part of the American Law Institute estate and gift tax recommendations adopted in 1968.[36] The recommendation is in two parts. The first part states that the Internal Revenue Code should define what constitutes a disclaimer. The second part states that a timely redirection of the destination of a property interest should be regarded as a disclaimer for the purpose of determining the transfer tax consequences of the original transfer. Under this proposal the disclaimant would be able to determine the person or persons to take the property as a result of the disclaimer, unless the alternative takers were designated by the will or trust of the original transferor. If that general approach is adopted, refinements would be needed which the ALI did not attempt to provide.

It would be highly desirable to have a comprehensive statute which fully and completely defines the qualifications for a disclaimer and interests that may be disclaimed. In this regard the ABA Tax Section recommendation[37] mentioned earlier might serve as a guide since it was an effort to draft such a comprehensive federal statute using the best of features found in the Uniform Acts and various state laws.

The manner in which the disclaimant may redirect the disclaimed property should undoubtedly be restricted to some extent. For instance, the persons to whom the property may be redirected might be limited to family members and perhaps

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[35] Martin, supra note 2.
[36] ALI, Federal, Estate and Gift Taxation (1968).
[37] Supra note 3.

qualified charities. That would make the disclaimant's power similar to a limited power of appointment which generally is a non-taxable type of power.

The power to redirect should allow not only for outright transfers but for creation of split-interests and the usual types of families and charitable trusts. For tax purposes, everything should relate back to the donor or testator who created the interest being redirected. That would insure, among other things, that generation-skipping trusts could not be created by a disclaimer to avoid any taxes that could not have been avoided by the original donor or testator.

There are a number of good reasons for supporting this approach:

(a) It is fair and equitable for the taxing system to allow a measure of post mortem estate planning such as this would permit. It is not a loophole for use in larger estates where the donor or testator has already adequate estate planning advice. If he has had good advice, he is generally not going to leave it to one of his survivors to rearrange the estate plan. In any event, the proposal would not permit a survivor to accomplish any tax saving which could not have been accomplished in the first instance by the donor or testator. There are situations in which disclaimers can have the effect of increasing or decreasing the marital deduction, increasing the charitable deduction, shifting property to a smaller estate, and perhaps causing a generation skip, but this is all true under present law. The difference between present law and the proposal is that present law does not provide any flexibility; it simply depends upon a rigid state law as to who the alternate taker or takers might be in the event of a disclaimer, unless the will or trust happens to provide for the alternate takers. It seems to me that allowing a disclaimant to redirect the property among family members would be most useful in moderate sized estates where the planning was not adequate in the first instance. In those situations there is a great deal of equity in allowing the family to do some shifting without incurring adverse tax consequences.

(b) The proposal as outlined would establish uniformity throughout the United States so that all taxpayers similarly situated would be treated the same for federal gift and estate tax purposes. Under the system proposed it would not matter what the state law rule might be concerning a disclaimer. If the disclaimer is qualified under the federal rules and if the disclaimed interest is properly and timely redirected by appropriate deed or other instrument it would qualify for federal purposes whether or not it would qualify for state purposes. This would eliminate virtually all of the complications and conflicts that exist under present law and provide real uniformity.

(c) The final reason is simplicity. The way to achieve real simplicity in the area of disclaimers, as with most complicated problems in estate planning, is to spell out completely and precisely all of the details required to be covered in order to interpret and apply the law. This is not terribly difficult to do with respect to disclaimers—it just has not as yet been done. If it could be done in a single federal statute that is comprehensive and fair and allows for a limited amount of flexibility in post mortem family planning, we would have meaningful reform.

Statement by Attorney Frank S. Berall of Copp, Brenneman, Tigh, Koletsky & Beralle, Hartford, Conn.

OUTLINE SUMMARIZING MAIN POINTS

I. Views expressed are individual ones and do not represent those of any organization.

II. Policy of estate and gift tax laws is to prevent concentration of large amounts of wealth and power.

A. Revenue raising is incidental and relatively unimportant.

B. Policy should be carried out without interfering with continuation of family farms and businesses or impairing living standards of surviving spouses or discouraging capital formation.

C. Reduction of costs of compliance and simplification of tax laws are important.

III. While other speakers are stressing importance of rate reduction and an increase in the unified credit, I will concentrate on the need to expand marital deduction, both quantitatively and qualitatively, conform the joint tenancy rules to actual practice, provide additional relief for illiquid estates of farmers, small businessmen and others, increase the $3,000 present interest gift tax exclusion and exempt transfers for consumption from the gift tax, complete unification of the gift and estate taxes by restructuring the provisions dealing with incomplete transfers and transfers within three years of death, revising the provisions concerning disclaimers, repealing the orphan's deduction, allowing the unified credit for gift tax purposes to be elective, broadening the ascertainable standard exception to general powers of appointment, returning the alternate valuation date to a year after death and the return filing date of 15 months after death and permitting elections even after the date for filing an estate tax return has passed.

A. Brief history of the present marital deduction and joint property provisions.

B. Proposal for expansion of the marital deduction quantitatively and qualitatively.

1. Unlimited tax-free transfers between spouses during life and at death are advocated.

2. This must be coupled with allowing the marital deduction for any transfer, which provides the donee-spouse with current beneficial enjoyment, even if the remainder is not disposable by the donee-spouse.

(a) All property receiving marital deduction in first estate must be taxed at death of surviving spouse as if it were part of latter's estate.

(b) Surviving spouse should be allowed to accept or reject qualification for marital deduction, in effect giving option to prepay death taxes on a life estate (as presently occurs) or to postpone their payment until termination of the life interest.

(c) Terminable interest rule should be abolished.

(d) Result will be increased flexibility in pre-mortem and post-mortem planning, without forcing people in second marriages to choose between the tax benefit of the marital deduction and protecting their children by a prior marriage.

C. Dealing with the liquidity problems of family farms, closely-held businesses, etc.

1. Technical improvements to and simplification of the special use valuation rules is essential.

2. Alternatively, consideration should be given to replacing the concept of special use valuation with a phased-in forgiveness of the estate tax attributable to farms and closely-held businesses.

3. Definition of closely-held businesses eligible for deferred payment of estate taxes should be broadened, the most liberal rules of the existing deferred payment election sections should be adopted and expanded and objective standards should be set to determine reasonable cause for extension of time for payment of estate tax in all cases.

D. The $3,000 present interest gift tax exclusion should be increased in line with inflation and transfer-for-consumption should be excluded from the gift tax base.

E. Transfers within years prior to death (except for gift taxes paid on them and transfers with respect to life insurance policies) should not be included in the gross estate.

F. The uncertainties and problems with respect to disclaimers should be cleared up and solved.

G. The orphan's deduction should either be repealed entirely or simplified so that normal family trust dispositions would qualify for it, where there are eligible orphans who are beneficiaries.

H. The alternate valuation date should be lengthened to a year after death and estate tax returns should not be required until 15 months after death.

1. This was the way the law was before 1971.

2. Estates large enough to require the filing of federal estate tax returns are less than 3 percent of all estates under present law and in many instances it is difficult if not impossible to obtain all necessary data for filing a return within the 9 month period following death.

3. Earlier distributions of estates has not been facilitated by the 9 month (as against the 15 month) filing requirement, since in most instances extensions are requested and granted.

4. The period of time during which changes in values occur after death should be a full year, rather than the present 6 months.

I. The alternative valuation date election and other elections which can only be made on timely filed estate tax returns should be permitted even if a return is filed late, since other penalities exist to deter late filing.

IV. Conclusion.

Statement of Individual Views of Attorney Frank S. Berall

The views expressed in this statement and the proposals for changes in the federal estate and gift tax laws advocated herein are the individual views of Attorney Frank S. Berall. None of the professional groups with which he is associated have authorized him to submit this statement for the March 24, 1980 hearings nor to appear on their behalf at these hearings. None of these groups have provided any financing for the reproduction of this statement or to pay any of the expenses incurred by Attorney Frank S. Berall in appearing at the hearings. All of the views expressed in this statement are the individual views of Attorney Frank S. Berall and are not to be considered as the official position of any organization to which he belongs.

SUMMARY OF STATEMENT

The basic goal of Congress in originally enacting federal estate and gift tax laws and in the subsequent changes which have been made to them has been to prevent the concentration of large amounts of wealth and the power that goes with it, in the hands of a relatively small number of families. Revenue raising has been only an incidental and relatively unimportant consideration. In fact, the receipts from the estate and gift taxes in 1980 are estimated at five billion dollars out of total federal tax collections of six hundred billion dollars. Thus the estate and gift taxes amount to about eighty three hundredths of a percent of federal revenues.

While using estate and gift taxes to prevent a build up of excessive accumulations of wealth from one generation to another is established policy, it is most important not to interfere with the national objectives of encouraging continuation of family businesses and farms or impair the standard of living of a surviving spouse. It is equally important to eliminate disincentives to capital formation and to encourage venture capital to invest in new enterprises to provide health growth in the private sector of our economy. Finally, effective tax administration, holding down the cost of complying with the tax laws and collecting taxes, coupled with the maintenance of respect for our system of voluntary compliance require that the furtherance of all these objectives be carried out with due regard for the need for simplification of the Internal Revenue Code.

It has become increasingly clear in recent years that the complaints by fiduciaries and beneficiaries of estates all over the country of unnecessary delays and extra costs of estate administration have arisen not so much as a result of antiquated systems of probate but rather from administrative problems created by the federal and state death tax laws. There is a need for a closer intergovernmental relationship as well as for leadership from the federal government to persuade the states to conform their death tax systems to the federal estate tax, so as to simplify the collection of death taxes at both levels of government.

The extensive changes to the estate and gift tax laws made by the 1976 Tax Reform Act and subsequent legislation need further revision and refinement to eliminate features which are counterproductive and tend to defeat the above mentioned objectives. The pending repeal of carryover basis is the first major step in the right direction. But, now that this ill conceived device has all but been eliminated from the tax laws, it is time for the Congress to take a close look at the entire structure of the federal gift and estate taxes to correct many of the flaws that have become increasingly apparent as practitioners and the Internal Revenue Service have obtained experience under the changes in law made over the last few years.

The generation-skipping transfer tax, an entirely new concept in the tax laws which was enacted as part of the Tax Reform Act of 1976, also requires study. However, while the problems that are becoming apparent in this area of the unified transfer tax system are serious ones, due to the nature of the generation-skipping tax itself there has been far less experience with it in operation than with the other 1976 estate and gift tax changes. Thus, it would be better to postpone any consideration of the generation-skipping tax until some of the more urgent problems already apparent in the federal estate and gift tax components of the unified transfer tax structure have been solved.

The principal areas of concern of the author of this statement are with the fundamental concept and philosophy of the marital deduction itself and the rules governing joint tenancies with right of survivorship and tenancy by the entireties, since these areas require scrutiny and revision in order to make the tax laws conform to the property concepts that many married couples have and provide security for surviving spouses. While the present rates of the unified gift and estate taxes in the kind of inflationary era we are in operate far too harshly on the small and medium sized estates, and the need for a comprehensive overhaul of the rate structure and an increase in the exemption is paramount to accomplish the above stated objectives, this statement does not deal with rates or the exemption because they are being covered extensively in the statement and testimony of Attorney J. Thomas Eubank of Houston, Texas.

The problems encountered by the family of a deceased farmer, small business owner and owners of other relatively illiquid assets include the difficulties in raising sufficient cash to pay death taxes and estate settlement charges without having to liquidate the farm, small business or other assets. If liquidation occurs, these most important small businesses either lose their identity by merging with larger firms in order to survive at all, or else are totally destroyed in sales at a sacrifice price. The existing provisions designed to deal with these problems, such as the special use valuation rules, the extended payout rules for estate taxes and the rules permitting stock redemptions from an estate to pay taxes and estate settlement charges without dividend consequences do not give sufficient relief.

In addition to the major areas of rates, marital deduction and joint property and the rules designed to provide liquidity, there are numerous other provisions in the gift and estate tax laws which should be revised in the interest of a fairer and more effective transfer tax system. These include the rules governing incomplete antemortem transfers, transfers within three years of death, disclaimer, orphans deduction and certain other technical matters, all of which are covered in this written statement.

STATEMENT

A. Philosophical guidelines

The policy objectives of the leaders in the movement which led to the enactment of the federal estate tax in 1916 (which had been preceded by a federal inheritance tax and then a period of time without any federal death taxes) were primarily to break up large accumulations of wealth, with revenue raising only a secondary consideration. President Theordore Roosevelt, before leaving office in 1909, referred to the malefactors of great wealth and the need to curtail their power. His views were shared by many in Congress who, seven years later, helped pass the federal estate tax. The federal gift tax was initially enacted in 1926, repealed in 1928 and reenacted in 1932. Its primary objectives were to prevent avoiding the federal estate tax and prevent reduction of income taxes by splitting income producing property among family members and trusts.

While the post-enactment history of the federal estate and gift tax law shows that over the years there has been little consensus as to whether their purpose was to control large fortunes or raise revenue, these taxes have in fact produced a relatively small portion of total federal revenues (now less than one percent). Therefore, the present justification for having these taxes with all the damage they do to small businesses, family farms and surviving spouses must be to prevent excessive concentration of wealth.

However, this purpose, and the efficiency of the tax system in achieving it, cannot be the only criteria to be applied in judging the tax system. Other significant criteria include the stability of the system under which estates can be planned in reliance that major changes in the law will not render the plan useless (or worse) by the time the property owner dies; the understandability of the system, at least to the average attorney, so that it can be dealt with competently in carrying out the clients' wishes (while an equitable system is desirable, it is not always possible to develop a simple and understandable tax structure that is equitable—striving for equity often results in complexity, creating problems of understandability to property owners and their attorneys); the neutrality of the system, so that actions need not be distorted to achieve tax objectives; and the certainty of the system (a corollary of both understandability and neutrality). The latter principle was recognized by the Congress in keeping the federal estate and gift tax laws substantially unchanged from 1948 through 1976.

Achieving certainty of application of the estate and gift tax laws sometimes runs counter to obtaining complete equity since, in striving for the latter, uncertainty is all too often created. (A key illustration of this is what happened to the provisions taxing accumulations trusts during the enactment of the Tax Reform Act of 1969, with further changes made to them in 1976, still leaving an unduly complex structure). This is more important from the standpoint of the property owner than from that of his lawyer, since uncertainty in the application of the tax laws creates additional costs for the property owner and increases his lawyers' fees.

Another desirable principle is that the laws apply uniformly to similarly situated taxpayers. However, it is not always possible to achieve these results without foregoing other objectives. For example, an unlimited marital deduction (or even the present greater of $250,000 or fifty percent marital deduction) penalizes people who die unmarried. An argument could be made that one's marital status at death should not determine the amount of the federal estate tax; on the other hand, the elimination of the marital deduction would bring back the inequities that existed between the eight community property states on the one hand and the rest of the country on the other, prior to the Revenue Act of 1948. It would also run counter to the social policy of easing the impact on the surviving spouse of the estate tax on the estate of the first to die.

The rights of the taxpayer must also be considered in any tax system. The taxpayer (in the case of the Federal estate tax, it is the decedent's estate), if insufficiently liquid will find that the payment of the federal estate tax imposes a great hardship, sometimes forcing the sale of family farms, ranches or small businesses or the loss of the family home. Easing the burden of the tax where an estate's assets are relatively illiquid is an extension of the ability to pay principle since, in an illiquid situation there is inadequate ability to pay the tax without forced sales.

Last, but not least, taxpayers should have the right to expect an efficient system of tax collection. In most cases this should lead to the earlier closing of estates, while providing for extensions in those situations involving lack of liquidity or other hardships.

B. Interspousal tranfers and joint tenancies

The nature of inter vivos and death-time interspousal transfers and how to tax them has never been satisfactorily resolved, although it was first dealt with when Congress established the marital deduction for transfers of separate property in the Revenue Act of 1948 and then again in the liberalizing changes made to the gift and estate tax marital deduction by the 1976 Tax Reform Act and the Revenue Act of 1978. The marital deduction was originally adopted in an effort to bring about greater equality in the operation of the gift and estate tax laws in community property and common law states. In view of the fact that community property is divided between husband and wife on a 50-50 basis, the marital deduction was originally limited to about 50 percent of the donor spouse's estate. More precisely, the gift tax marital deduction is the first $100,000 and then 50 percent of the excess over $200,000 of each gift from one spouse to the other, and the maximum estate tax marital deduction is the greater of $250,000 or 50 percent of the deceased spouse's adjusted gross estate.

The interest of each spouse in community property is ordinarily the equivalent of outright ownership, subject to the managerial control of the community property that may be vested in one of the spouses. In particular, a spouse's interest in community property does not ordinarily terminate on death.

Thus, the so-called terminable-interest rule was developed under which transfers to a spouse of certain terminable interests do not qualify for the marital deduction. In other words, generally speaking, the donee spouse must receive an interest somewhat equivalent to outright ownership, for the gift to her to qualify for the marital deduction. The technical requirements to qualify an interest other than outright ownership for the marital deduction are fairly complex, and the Internal Revenue Service and many courts have taken a highly technical approach to these requirements, with the result that all too frequently good faith efforts to meet the legal requirements have failed.

In community property states, except for a partial marital deduction for the excess of the $250,000 minimum marital deduction over the deceased spouse's share of the community property (known as the community property adjustment) the marital deduction is only available for separate property. Under certain circumstances, moreover, separate property of one spouse that reached that character as a result of the conversion of community property to separate property is tainted for marital deduction purposes and must still be regarded as community property in working out the marital deduction. In effect, the maximum marital deduction available in a community property state for death time transfers consists of the community property adjustment and approximately one half of the value of the non-tainted separate property, but transfers on death of community property cannot be utilized to make up the allowable marital deduction since only half of the community property is includible in the adjusted gross estate (the base for the marital deduction). There are several problems which exist here. First of all, the unified gift and estate tax transfer laws, despite the above two mentioned changes and numerous tinkerings with the survivorship property rules in 1954, 1976 and 1978, are still not in accord with the real life assumptions with respect to marital property held by the average taxpayer in this country.

It would not be an overstatement to say that there is no single problem which gives more trouble in estate planning and administration than interspousal transfers made without any advance awareness of the fact that they are gifts, causing great difficulty to those of us who are obliged to advise couples that they have made unreported gifts which, whether or not they are immediately taxable, nonetheless require the filing of gift tax returns and the impairment of the exemption equivalent to the credit against the unified estate and gift tax. If any of these couples should go to some other practitioner who either out of ignorance or by design fails to advise them of their need to comply with the gift tax laws, they might be better off in terms of lowered compliance costs (mostly legal fees) if not actual taxes, than if they went to a more knowledgeable or more ethical practitioner.

Many, if not most married couples basically approach property acquired by them during marriage as "our property." The eight community property states (and Puerto Rico) have adopted this concept to a greater or lesser degree, at least with respect to property acquired after marriage from sources other than gifts or inheritances. The concept of survivorship property (whether it be a joint tenancy with right of survivorship or a tenancy by the entireties) is a commonly used title holding device in all of the other (common law) jurisdictions in the United States, and is used to some extent in the community property states, as well.

This portion of the statement will first explain in greater detail the property law concepts underlying interests held by married couples in survivorship, gift and estate taxation of these properties, inconsistencies with state law treatment, and problems with the existing federal estate and gift tax treatment. This will be followed with a proposal for unlimited tax-free inter vivos and death-time transfers of property between spouses (hereafter sometimes referred to as the quantitative expansion of the marital deduction). In the opinion of the writer of this statement, this must be coupled with the elimination of the restrictions imposed on transfers qualifying for the estate tax marital deduction (hereafter referred to as the qualita- tive expansion of the marital deduction). These restrictions prevent the first spouse to die from being able to direct disposition of the marital share left the surviving spouse, following the latter's death. If they are eliminated, then the property in the marital deduction share should at the death of the surviving spouse be taxed as an additional asset in his or her estate. Alternatively, upon an election not to postpone tax on the marital share the surviving spouse could forego part or all of the marital deduction and have the property taxed in the estate of the first spouse to die.

1. *Property law concept*[1]—Two of the most widely used forms of intramarital property ownership are joint tenancies and tenancies by the entireties (usually referred to in this text collectively as "joint tenancies" or "joint ownership"). The single most distinguishing characteristic of a joint tenancy is its "survivorship" feature. Upon the death of one spouse the title (and full ownership) or a jointly-held asset passes to the surviving spouse. This right of the survivor to the property is not generally affected by the decedent's will, other testamentary documents, or by laws relating to intestacy.

On its surface, this form of ownership appears to carry into reality a typical and normal intramarital attitude that "what is mine is yours". The apparent simplicity and the perceived normality of the arrangement act together as a running tide and lead many spouses to blind and unsophisticated ownership of their property in joint tenancy. When the blindness is cured, a tangled and confusing web of potentially disastrous tax results and frustrated dispositive desired becomes visible. The pity is that what starts out as a legitimate quest for a symbolic "oneness" is ownership of the marital property ends as an almost infinitely complex pattern of results at cross purposes with those sought. No sinister acts or motives bring this about—it derives from the application of little-known provisions of the federal gift and estate tax laws. Seldom is a responsible canvass of these laws made on creation of a joint tenancy. At a later date, often accidentally, the consequences are studied and reviewed and by then the entrapment is apparent. The basic position put forward here is that such a frequent and regrettable series of events derives from an irrational and little enforced statutory pattern which can and should be altered to remove from the arena of tax-entrapment inter-spousal acts of a widespread nature which currently run afoul of an unduly complex and little-known area of the law for which no sensible enforcement mechanism exists or has ever been conceived.

2. *Gift taxation of jointly-owned properties.*—The federal gift tax comes into play in two aspects of joint ownership: its creation and its termination during life.

(a) Creation: When personal property (other than joint bank accounts and co-owned government securities) is purchased or transferred into joint ownership, in many cases a taxable gift occurs. The question of gift or no gift is determined by the source of funds used to purchase the property. A gift is made when one spouse contributes disproportionately to the interest he or she receives. For example, assume Dr. Mary receives her share of profits of $25,000 from her professional corporation and decides to invest the money in the stock market. When the family broker arranges the purchase, it is most likely that he will recommend, or perhaps decide without consultation, that the stock be titled in the names of John and Mary as "joint tenants with right of survivorship" or a functional equivalent creating a "joint tenancy". For normal and usual interspousal reasons, this will, in all likeli- hood, be the form of title. At this point, Mary has made a gift to John of $12,500. This is because Mary provided all of the funds for the purchase but received a state law property interest in only one-half of the assets.[2]

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[1] Paragraphs numbered 1 and 9 were adopted and updated from materials originally prepared by Attorney William P. Cantwell of Denver, Colorado.

[2] In tenancy by the entireties situations, because neither spouse alone can terminate the tenancy, the actual proportionate property interests are determined by reference to actuarial tables so that the gift would not be of exactly one-half except in those few situations where the tables yielded such a result.

Real property purchased prior to January 1, 1955 was treated in a similar manner. To reduce the inadvertent gifts so frequently made in the acquisition of realty owned by married couples, Internal Revenue Code Section 2515 was adopted in 1954. This provides that no gift is made upon the creation of an interspousal joint tenancy in real property unless treatment as a gift is affirmatively elected on a timely filed gift tax return. In other words, without the election the spouses own the real property in proportion to their contributions for federal gift tax purposes. Howevr, by filing a timely election the spouse who contributes more than his or her proportionate share may treat the creation as a gift to the spouse contribution less than his or her proportionate share.

The jointly-held bank account and co-owned government security present still another complication of the joint property mystique. Here there is no gift tax on creation as such, but withdrawal of more than one's own contribution without accountability for that withdrawal is a taxable event.

There are thus three sets of gift tax variables at creation of a joint tenancy for the married couple to bear in mind. Acquisition of stocks, bonds, and all property except real estate, bank accounts, and co-owned government securities results in a gift without any other action than acquisition in joint form if the purchase was not made with funds "owned" in the same proportion as the property interest acquired. Real estate results in *no* gift on the same facts, but it can be a gift if affirmative action is taken. Bank accounts and co-owned government securities result in no gift at creation but may result in a gift if a noncontributed amount is withdrawn without accountability. This is just the beginning, but John and Mary can be forgiven if they are already confused!

The 1976 Tax Reform act added a new fractional interest rule which provides that where a "qualified joint interest" is created between spouses after 1976, only half of its value is included in the gross estate of the first spouse to die. Among other requirements to obtain a qualified joint interest are that in the case of personal property, the creation of the interest must have been a gift subject to federal gift tax and in the case of real property, the donor must have elected to treat creation of the joint tenancy as a gift for federal gift tax purposes. The other requirements are that the interest must have been created by the decedent or the decedent's spouse or both after 1976 without any other joint tenants.

In the case of pre-1977 joint tenancies, a qualified joint tenancy can be created by severance of the pre-1977 joint tenancy and recreation in a transfer subject to gift tax. The 1978 Revenue Act added an additional provision to the effect that if a donor-spouse elected to report a gift of the property in a gift tax return filed with respect to any calendar quarter in 1977, 1978 or 1979, the pre-1977 joint tenancy does not have to be severed and recreated, but the donor-spouse making the election is treated as if he made a gift for the calendar quarter for which the return is filed. The gift equals the appreciation attributable to the donated portion of the consideration furnished by the donor-spouse at the time of creation of the joint tenancy.

The need for actuarial computations in determining the amount of the gift when a joint tenancy in real or personal property is created after 1978 has been eliminated, unless the fair market value of personal property can be ascertained only with reference to the life expectancy of one or both of the spouses.

The above described provisions, added by the 1976 and 1978 Acts have received a very cold reception by knowledgeable estate planning lawyers, accountants and trust men. Well advised clients do not create qualified joint tenancies out of pre-1977 survivorship property. A far better way of handling this property is to sever it into a tenancy-in-common or have a complete transfer made of it to one or the other of the spouses. Furthermore, estate planning practitioners rarely if ever advise the creation of any kind of joint and survivorship property (the one exception might be to hold real property in joint tenancy in a non-domiciliary jurisdiction, to avoid ancillary probate there), and the new qualified joint tenancy is inferior to other methods of holding property.

Unfortunately, the majority of people and their less well informed advisors are attracted to joint tenancy and have become even more confused than before by this additional option added by Congress. It is recommended that all of these provisions be repealed and the law restored to the way it was before the 1976 Tax Reform Act with respect to joint and survivorship property except that with respect to interspousal transfers, only 50% of this would be included in the first decedent's estate. If an unlimited marital deduction is adopted, this should preclude any need for having special provisions governing joint tenancy property held by spouses.

(b) Termination: The second time John and Mary may run afoul of the gift tax laws is upon termination of a joint tenancy during life. For personal property and real property acquired prior to 1954, a gift occurs when one spouse receives more than his pro rata (one-half) share of the property held in joint tenancy, without regard to contribution. For joint bank accounts and co-owned government securities, a withdrawal in excess of contribution without accountability operates as a termination as to those assets and a gift to the withdrawing spouse. For tenancies by the entireties, a gift occurs if one spouse receives more than his actuarially-determined interest. For real property acquired after 1954 as to which no election was filed, a gift occurs if the spouses do not divide the proceeds on the basis of their respective contributions.

In the case of termination of a qualified joint interest (the creation of which was a taxable gift) severance into a tenancy-in-common will not have any gift tax consequences, but should the entire property or its proceeds be put into the sole name of one or both spouses, the result will be a taxable gift.

3. *Estate taxation of jointly-owned properties.*—The scheme for taxing jointly-owned properties other than tenancies in common upon the death of either spouse has some surface aspects of rationality, but is an administrative disaster area for the taxpayer. At the death of the first spouse, Section 2040 includes in his estate subject to tax the value of the jointly-held properties proportionate to his or her contribution to the cost of acquisition. For example, if John died owning $200,000 worth of stock in joint tenancy with Mary and if John had provided all the funds to purchase the stock, the entire value of the stock is included in his gross estate for federal estate tax purposes. This is true even if a gift occurred upon the creation of the joint tenancy, although any gift tax paid upon the creation of the joint tenancy may be applied as a credit against the estate tax.

Suppose, on the other hand, that Mary had worked and that her efforts resulted in a contribution to the cost of the stock. Value proportionate to that contribution can be *excluded* from John's gross estate. Yet to achieve that result, John's executor faces a monumental task, and he is specifically given the burden of proof under Treasury Regulations Section 20.2040-1(a). To discharge it, he must "trace" the respective contributions of John and Mary to the cost of acquiring the property in question. In many instances, this may involve looking back 10, 20, 30, or more years. Needless to say, it is often impossible to trace with even a semblance of accuracy because these types of records rarely exist and few memories are accurate over such a period.

For example, assume that a deceased John and his surviving Mary purchased 100 shares of XYZ stock in joint tenancy in 1940 for $2,000. To the best of her recollection, Mary believes that this $2,000 came primarily from John's salary but that she contributed $500 from her savings prior to the marriage. She is justifiably vague about this, however, and has no records of any kind to substantiate it. Through a prudent sale of this stock and investment of the proceeds in various stocks, John and Mary had $200,000 worth of stock in joint tenancy at his death. Mary's $500 now prorates to $50,000 and John's $1,500 to $150,000. However, all of the $200,000 is included in John's gross estate because Mary cannot prove she contributed $500 to the purchase price of the original stock. Such is the consequence of an inability to "trace" an event that occurred 35 years earlier—hardly a rational way of taxing anything.

This inability to "trace" the contributions is a result of the same interspousal attitude which created the joint tenancy. John and Mary quite typically tended to view their assets as "ours" and it would have been inconsistent—a veritable breach of faith—to document the source of funds used to purchase property. In the previous example, that attitude would cost John's estate in estate taxes from little up to the full marginal rate, depending on other variables.

The tracing requirement, under penalty of potentially heavy taxation if it cannot be done, adds another complex rule for John and Mary. In practice they are virtually never aware of it at the time the crucial acts are occurring, and consequently almost never prepared to meet it. Even a sophisticated and studied couple preparing affirmatively to meet the burden would have a monumental task. The record keeping would be interminable—a virtual career of premortem planning, for the records would have virtually no other use than in establishing the estate taxes in the first decedent's estate.

4. *State law inconsistencies.*—Both the federal gift tax and estate tax laws tend to run inconsistently with state law concepts of the ownership of joint tenancy property. In a true joint tenancy, either individual is able to terminate the joint tenancy by a conveyance to a third party. The third party will be deemed to receive his portion of the asset as a tenant in common with the remaining original joint tenant. Thus, there is an "ownership" right in each joint tenant sufficient to support a transfer of that joint tenant's fractional ownership to a third party under state law. It exists without regard to how the interest was acquired, whether by gift or for consideration. There is, however, no such "ownership" for purposes of the federal

estate tax if the particular joint tenant acquired his right by gift, or is unable to "trace" contributions which may have been made to the acquisition cost.

A tenancy by the entireties shows some differences here, for no conveyance by either of the tenants by the entireties is sufficient to transfer title in the absence of a joinder in the conveyance by the other tenant.

There are additional problems and differences with state laws, such as rights to income, rights to encumber, rights of creditors, state gift and death tax laws, and a host of variables. To compound confusion there is also the problem of the commingling of joint tenancy property concepts with community property concepts, and the inevitable variances among the community property jurisdictions in dealing with this dilemma.

This discussion assumes that the vast majority of states recognizes that each joint tenant does in fact have a property right, and that it extends to a pro rata share of the underlying property—i.e., two joint tenants—each owns one-half interest; three—each owns one-third, etc. While it less clear in entireties situations, it is also assumed that there is a state law recognition of a property right in each spouse, but its qualification is based on an actuarial computation rather than on a simple proration as in the joint tenancy situation.

While it is acknowledged that federal tax law need not necessarily be bound by state law concepts, the Congress should be aware that the more numerous the differences the more confusion for the taxpayer. The point is that there are few areas of common experience for American taxpayers which are more confusing than the joint property area and that such confusion, largely based on taxation statutes, is irrational, counter-productive and should be eliminated. Since the most frequent owners of joint interests are husband and wife any step that tends to lessen confusion in the interspousal area is a big step in the right direction.

5. *Problems with the existing Federal estate and gift tax treatment.*—The efficiency of a tax system can properly be tested by its effectiveness in revenue raising and by its administrative enforcement and equitable application. It is submitted that the federal estate and gift tax system of interspousal acquisition, ownership, and disposition of jointly-owned property is defective on all of these counts.

(a) Revenue raising: The adoption of Section 2515 in 1954 appears to have been a clear recognition of the ineffectiveness of the joint-tenancy provisions to raise revenue by the federal gift tax. Certainly, husband-wife ownership of realty is a significant economic event—for most couples the most significant lifetime accumulation of capital they make. If the release of the revenue from so widespread a taxable event was justified—presumably because of widespread noncompliance with the gift tax laws—then we may assume retention of the balance of the scheme can raise little revenue. While the matter of compliance and enforcement is interrelated with revenue raising, these points are separately discussed.

In final analysis, it is certainly not the revenue burden on the taxpayer that is at the heart of the jointly-held property problem. A scheme of taxation of such property raising identical or greater revenue should be fully acceptable if it could be fairly administered and enforced and if it was capable of equitable application to all taxpayers in functionally equivalent situations. While actual revenue statistics were unavailable to the writer, it is unlikely that they are very great in the joint tenancy gift tax area. The other deficiencies in the system far outweigh the revenue involved.

(b) Administration: There are thorny and difficult aspects of the system which present abnormally complicated administration problems. Many of the elements are subjective. Others depend on less than satisfactory evidence. Still others are subject to no mechanism for verification.

A subjective element is the "inadvertent gift". What happens when the consequences of a transaction under the statute characterize it as a "gift" and no action of any kind is taken because there is no knowledge of the provisions of the statute? Is intent a factor? Should it be? How is intent formulated subsequent to a transaction to be interpreted? Many practitioners have suggested that arguments be advanced that John and Mary had a "partnership" in the farm, ranch or business, even though nothing consistent with a partnership ever occurred contemporaneously with a series of acquisitions in joint form. The formulation of that intent would be after the fact. Should it control?

In the 1978 Revenue Act the concept that spouses were in partnership was added to permit estates of decedents dying after 1978 to elect to reduce the value of jointly and closely-held farm and business property to reflect both an interest factor on contributions made to acquire the property and a factor for materially participating in the operations of the enterprise. The amount excludible from the full value of an eligible joint interest otherwise includible in the gross estate is determined by a formula permitting a reduction of two percent for each year the surviving spouse materially participated in the business (up to a maximum of 50%). This percent is then applied to the excess of the value of the joint interest over the sum of the original consideration furnished by the decedent plus assumed appreciation at the rate of six percent simple interest for the period it was invested in the farm or other business and the original consideration furnished by the surviving spouse plus assumed appreciation at the same rate and for the same period (this is known as the adjusted consideration).

After applying the percentage rate to the excess of the value of the joint interest over the adjusted consideration, the adjusted consideration furnished by the surviving spouse (that is the amount of the surviving spouse's original consideration plus assumed appreciation at the rate and for the period described above) is then added, getting the amount excludible from the value of the jointly held interest otherwise includible. For the purpose of the formula the determination of whether the surviving spouse materially participated in the business in a given year is made in a manner similar to the manner used with regard to net earnings from self-employment under Section 1402(a)(1), thus leaving the last word as to a definition to future regulations. The election is to be made according to regulations and must be made no later than the time for filing the estate tax return plus extensions. The adoption of unlimited tax-free interspousal transfers would avoid the need for these and many other complex provisions.

Where the election is unavailable (which will be in most cases) tracing must be done, unless the executor decides to concede includibility of the entire amount of the joint property. No one who has ever endeavored to "trace" can be satisfied that there is adequate hard evidence available. Gaining the evidence that is available is expensive, time-consuming, and subject to abuses, oversights, and conflicts. An absence of evidence, or even of a casual recollection, can lead to inequities.

What machinery for detection and verification exists with personal property acquisitions? Joint account withdrawals? Billions of dollars in stocks and bonds and bank accounts exist in joint form without any administrative mechanism to trigger the filing of necessary gift tax returns. Who does "own" the reservoir of funds in a joint bank account to which each member of a married couple contributes from separate and similarly compensated employment? How can such respective "ownership" be verified? In point of fact, most "tracing" proceeds on the basis of determining the existence of a ratio of ownership in such a reservoir, followed by imputting a supposed usage of funds in that ratio to acquisition of an asset. That is a patently inaccurate process, based on suppositions indulged in only for tax purposes. The fact is that the commingling was perceived of as making the funds "ours" with direct ownership abandoned in the process.

(c) Enforcement: Enforcement is the other side of the administration coin. It is one of the truly weak links in the joint tenancy tax system.

Realization of income is subject to a series of objectively verifiable evidences—chief among them being the withholding system and the information return. In the case of the income tax such enforcement mechanisms as withholding and information at the source reporting contribute to enforcement. There is no analogous system under the gift tax law and one is often innocently unaware that a gift with tax consequences—has occurred.

There is no alerting signal when joint property is acquired as there is in the income tax area, for example, when withholding information is filed. And while newspapers and television are filled with advertisements for income tax services and "tax tips" from preparers, the kind of information available on the gift tax consequences of joint tenancy acquisitions is often misinformation. Indeed, much of the problem may very well stem from an extraordinary level of dissemination of misinformation in the area. How many inadvertent gifts (unreported as well) have occurred from advice on title holding given to a married couple by a stock broker, realtor, banker, or car salesman (indeed, by an ill-informed lawyer or accountant)? "Everybody takes it in 'joint'" goes the homily, and John proceeds to open a joint brokerage account, acquire stocks in joint tenancy, buy the house in joint tenancy, open a joint bank account, and buy the car in joint tenancy, because "everybody" must know what they are doing!

If this is occurring on a wholesale basis, there are inadvertent gifts being made, yet no system of reliable detection and enforcement exists. The sophisticated citizen, seeking and acting on accurate advice, is at a disadvantage. His proper disclosure, filing, and payment of tax when appropriate is a lonely performance in an area where "everybody" is certainly not doing that.

An enforcement system would do at least two things, and possibly a third. First, it would raise the awareness of the problem. Second, it would result in a more evenhanded treatment of all taxpayers. Finally, it might raise revenue, though the curious nature of the acquisition of joint holdings leads to skepticism on this point.

Buildups of joint property are generally of an "installment" type. Stocks are bought a few shares at a time. Homes are acquired with mortgages paid off over years. It seems a fair statement to suggest that the gift tax marital deduction and annual exclusion would cover a great many situations and thus little revenue would be raised by better enforcement mechanisms.

(d) Inequity: Leaving aside every other objection to the joint property problem than inequity would still leave a completely persuasive case. The two major statutory revisions in the area that have occurred sought to deal principally with the inequity problem. Though they helped, they were still too little to accomplish the appropriate result. The reference, of course, is to the Revenue Act of 1948 and the addition of Section 2515 by the 1954 Code. They first sought to create equality between citizens of community property statec and common law property states. The second sought to de-fuse the widespread noncompliance in husband-wife acquisitions of jointly-held realty. It is submitted that neither of these revisions went far enough and the complexities introduced in 1976 and 1978 have not helped the situation.

Inequity goes beyond the statutory scheme. Uneven administration and enforcement are additional sources of inequity. How many inequitable results have occurred because "tracing" could not be achieved or achieved with any degree of reliability? How equitable is it to accept the proper and timely returns and payments of a careful and sophisticated taxpayer while taking no steps to identify and require compliance from ill-advised taxpayers who are doing what "everybody" does?

With respect to inequity at the level of the statutory scheme, the major chore is to complete what was left unfinished in 1948—the matter of interspousal transfers. An example helps: John and Mary Community Property versus John and Mary Common Law Property.

John and Mary Community Property spent a lifetime of effort and accumulation. John always worked and Mary never was gainfully employed. They own all of their property as community property, and at John's death his one-half of the community yields a taxable total in his estate of $250,000 on which a federal tax of $21,400 is paid. At Mary's later death, her half of the community, likewise worth $250,000, is taxed and another $21,400 is paid. John left his half of community in a form which was not taxable at Mary's later death. If the sequence of deaths is reversed, the result is the same.

John and Mary Common Law Property are a very similar couple. Equally diligent, equally loving. They do what "everyone" does in a common law state. They acquire all their assets in a joint tenancy. They view it as a substitute for a will, and John dies. So far, so good. He has an estate composed of the full $500,000 but he has a surviving spouse and the joint property qualifies for the marital deduction. So, his tax is $21,400 on his net estate of $250,000. Then Mary Common Law Property dies. Her estate is $478,600 (the $500,000 less the estate tax). Her tax is $92,209. The total taxes in both estates are $113,609. Mr. and Mrs. Common Law Property have paid a whopping $70,809 more in federal estate taxes than Mr. and Mrs. Community Property. If the sequence of deaths is reversed, the difference is also substantial. John's estate is $500,000 and there is no marital deduction. His federal estate tax is $98,800 compared to the $42,800 paid by his friends a few miles away in the community property jurisdiction, a difference of $56,000.

6. *A possible resolution of the problems.*—The preceding material is intended to catalog something of a horror story. It is a story with at least these chapters: Great complexity; Low public awareness; Widespread misinformation; Widespread noncompliance; Difficult administration and enforcement; Suspected low revenue production; Inequities among citizens of the same and of different states; and Insufficient past measures of correction.

If a case is made by these conditions, what then is a remedy?[9] As a bedrock beginning, it is submitted that a tax system which can integrate rather painlessly with what "everybody does" without unduly damaging the revenue is a desirable tax system. And what "everybody" (or a very large majority) tends to do in the marital property ownership area is to arrange that ownership in a way that suits

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[9] It has been suggested that an extension of Section 2515 to all interspousal joint tenancies would cure or ameliorate the situation. It is submitted that this would be unavailing to solve the major problem. Unless "tracing" at death was also eliminated, all of the present uncertainties and uneven treatment would persist, and they are a substantial part of the problem. In addition, a lifetime giving program to a spouse is often desired. Section 2515 is counter-productive to this because its effect is to rule out a gift at the time of creation of a joint tenancy unless an election is made. The election process is little known, and therefore frequently overlooked. When the facts become known, the property may have appreciated greatly and a completed gift by severing the joint tenancy may be very costly.

the particular purposes of the marriage while acting *as if* there were no federal gift taxes as far as husband and wife transactions are concerned. That translates to an existing pattern of interspousal transfers being made with a widespread and flagrant disregard of the existing federal gift tax laws. Since no great impetus to correct this appears to be forthcoming, it would appear to be a logical extension of the statutory efforts of 1948 and 1954 to "provide that no arrangement of property by and between spouses during life in any form of title in their names whatsoever will be a taxable event for purposes of the federal gift tax." In other words, there should be totally free lifetime interspousal transfers of property for federal gift tax purposes.

Admittedly this is a broad proposal to deal with the joint interest problem. However, the joint interest form of title holding is really just symptomatic of the whole area, although it symptomatizes the worst part of the disease.[4] To cure joint tenancy problems only while leaving other interspousal transfers as is would again create mass confusion. The suggestion is simply a "giveup" of a major area of misunderstanding, confusion and noncompliance. This would go far toward making the territory under exploration a civilized and settled one. Later portions of this testimony detail proposed and existing moderating elements to curtail reckless use of the privilege. These are an integral part of the proposal.

7. *What estate tax changes are desirable?*—What of the estate tax? Profound questions can be and have been raised by others concerning the estate taxation of "marital property" and interspousal transfers. The purpose here is not to address such broader questions, but to examine only the widespread use of joint property by married couples. As an extension of that concern, two estate tax problems are important. One is the estate taxation of jointly-held property. The second is the problem inherent in the free lifetime interspousal transfers proposed as a solution to the former when death occurs within three years of the transfer.

8. *Problems in estate taxation of jointly held property.*—The principal problem is that of tracing. Tracing is an extremely inexact activity, and the necessity of it to achieve a reasonable result is a heavy burden for taxpayers who never knew the problem was coming. There are undoubtedly many situations where inequities arise because of the absence of records or the absence of a surviving spouse in full possession of his or her faculties, including an accurate memory.

It would seem that this tracing problem should be susceptible of a reasonably simple solution. The problem is the inexactitude and inequity of tracing. It is submitted that a rule of certainty, easily applied, administered, and enforced, would be an answer.[5] The estate of the first member of a married couple to die owning jointly-held property would include one-half of the fair market value of that property. No tracing would be required or allowed. While it could be argued that the tenancy by the entireties situation should be treated differently, with the use of the actuarial value, as distinguished from a simple fraction of one-half, it is submitted that it is desirable to come reasonably close to a national standard which can be applied evenly in every state, and that the half and half treatment does this with no significant loss of revenue.

9. *Inter vivos interspousal transfers within three years of death.*—Regardless of the overall solution of the problem of transfers within three years of death, how should the suggested free interspousal lifetime transfer problem be handled? Let us first look at a situation more than three years before death which does not involve joint property. Despite his awareness of the unified transfer tax, John thinks that his estate planning will best be served by constituting Mary the owner of half of his assets. He transfers into her name alone some $250,000 of his $500,000 estate, retaining the other $250,000. Even though this gift is outright, John has no tax to pay because of a marital deduction of $125,000 plus $3,000 exclusion, leaving a net gift against which a portion of the exemption equivalent to the unified credit will be offset of $122,000. John dies leaving an estate of $250,000. His estate can still use $53,625 of the exemption equivalent to the credit and with an optimum marital

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[4] There is, for example, the nightmarish area of untitled personal property such as household furnishings. Some forms of tangible personal property, such as art and coin and stamp collections, can be repositories of considerable value. Few married couples consider their tangible personalty as anything other than "ours", though the laws of most states would not accept a conceptualized view as establishing joint ownership without more.

[5] This treatment would be appropriate whether or not there were free interspousal transfers at death. It would be a rule of certainty to simplify questions of the size of the gross estate of the decedent. If there were free interspousal transfers at death, it would simply be transferred under such procedure. If not, it would enter into computation of the marital deduction as joint property now does, but there would be a certainty of inclusion of only one-half of the asset in the gross estate, unlike the present "tracing" situation.

deduction provision there would be a marital deduction of $196,375. There is no tax on his estate.

At Mary's death, her estate includes the $250,000 given her by John and $196,375 received as marital deduction assets for a total of $446,375. The federal estate tax on her estate is $82,284.

John could, had he wished, have chosen not to use the marital deduction leaving Mary an interest in a nonmarital trust. Since his estate had only $53,625 of remaining exemption equivalent to the credit there would have been a tax of $52,498 and at Mary's subsequent death the tax on her $250,000 would be $21,400, making a total of $73,898. This gives a tax saving, as a result of not using the estate marital deduction, of $8,386. From a planning viewpoint this might not be worthwhile saving, considering the loss of the use of $52,498 during Mary's life after John's death but it illustrates the interaction of the taxes.

Now assume that the suggested free interspousal lifetime transfer provisions are the law, and that the transfer to Mary is beyond the three-year period. The big difference is that the unified credit is preserved in its entirety and can be used without diminution against the estate tax in each estate. This is equivalent to the usual situation in a community property jurisdiction. Equity demands that similar treatment be accorded married couples throughout the country.

Now take the same transaction into the three-year period. It would appear proper to assume that if a substantial donative transfer was to be made at a point in life which might be within three years of death it would be done with sophisticated advice. That advice would very typically be accompanied by the preparation of a dispositive instrument which would use an optimum marital deduction formula. Hence, even if gifts made turn out to be within three years of death the overall disposition of the estate after the transfer is grossed up under Section 2035 will still result in substantial tax saving at the first death. The gift might have resulted in tax, but this would be only after exhaustion of the exemption equivalent to the unified credit of $175,625 and full utilization of the $100,000 gift tax marital deduction.

It takes little imagination to conceive of circumstances in which very large transfers might be engineered from a death bed with a consequent heavy loss of early realization of revenue. To switch the tax timing on $3,000,000 from a terminally ill spouse to a healthy surviving spouse with no other assets would postpone realization of $444,400 in federal estate tax even assuming full use of the estate tax marital deduction. The figure for $6,000,000 of assets is $1,061,800 and that for $10,000,000 is $2,112,200. To postpone realization of amounts of revenue in this magnitude by admitted death-bed transfers is certainly beyond the purview of the suggestions being made here.

What then would be a sensible form of limitation on an otherwise exempt transfer to a surviving spouse during the last three years before death? The principal objective being urged here is to permit all U.S. estate taxpayers to "split" their taxable estates with their surviving spouses during their lives without gift tax consequences and with effectiveness for estate tax purposes. To await death to achieve this under the pattern set in 1948 means that it will not be achieved if the less affluent spouse precedes the more affluent spouse in death. In such cases lifetime transfers to achieve the split without risking the less reliable sequence of death seem to be the equitable answer. If Section 2035 is not all but repealed, as recommended elsewhere in this statement, then the concept of the "split" but no more should be structured into a revised Section 2035. This would call for a gross-up in the estate of a decedent of all transfers to a spouse with the three year period followed by includability in the decedent's estate of all assets in excess of half—essentially the same thing that happens in applying Section 2035 to qualified transfers to a surviving spouse under the Revenue Act of 1948.

Another brake on massive death-bed transfers in large estates is a reference to simple and intelligent estate taxation mathematics. It is readily apparent to the majority of estate planners that the use of a "100% marital deduction" or completely free lifetime interspousal transfer of all property to a surviving spouse would be appropriate only in small estates. So long as there is a graduated tax bracket, total taxes on both estates will almost always be higher if the entire quantum of the property of both spouses is taxed at only one time rather than two times. Simplistically viewed, the estate tax exemption of the first deceased's spouse is lost if all of the property is taxed at the death of the survivor. Perhaps then the overall situation would best be served by making it possible to use a free lifetime interspousal transfer or a "100 percent marital deduction" while leaving to appropriate professional application of planning concepts the way in which this particular privilege would be used.

10. *Inter vivos transfers of joint and community property.*—As previously mentioned, there should be a major change with respect to inter vivos interspousal transfers. The gift tax marital deduction, unlike the estate tax marital deduction, does not permit a 100 percent deduction for up to 50 percent of the estate. The gift tax payer gets a deduction for the first $100,000 (in excess of the annual exclusion) of the actual amount given to his spouse, no deduction for the next $100,000 and a deduction for 50 percent of the excess over $200,000. This means that returns must be filed for relatively small gifts, a requirement frequently ignored, leading to disrespect for the law on the part of many people and imposing onerous filing and payment requirements on the conscientious and well advised taxpayers.

The same policies that led to adoption of the Section 2515 exemption from the gift tax of the creation of a tenancy by the entirety or a joint tenancy with right of survivorship between husband and wife in real estate (in the absence of an election) should be expanded to many other interspousal transfers made inter vivos. Section 2515 should be extended so that all transfers into joint ownership, including community property transfers, by either spouse, regardless of the source of the funds, would be treated as exempt unless the spouses elected to have them treated as completed transfers. Thus, the umbrella of Section 2515, now limited to real estate, should be extended to stocks, bonds, savings accounts and all other types of property. Even tenancies in common should fall into this shelter, since the tendency of people in creating all of these joint interests is to give half of an aggregate amount, so that such a rule would really rather closely parallel the present policy on joint tenancy.

Under existing provisions of Section 2515, termination of a real estate joint tenancy between spouses or a real estate tenancy by the entireties may or may not result in a gift, depending on the ratio of original contributions and the property interests acquired. This is freqẹently the occasion for an inadvertent gift. Extension of Section 2515 to all types of property, without any attention to the inadvertent gift problem, would exacerbate the existing problems of noncompliance in this area. As an inducement to taxpayer awareness and compliance, a new type of taxpayer election in this area is suggested below.

Unawareness is the real reason that many transfers into interspousal co-ownership form are not coupled with elections to treat the transfer to the noncontributing spouse as a gift. Existing Section 2515 requirements requiring the election to be made on a timely return operate as a trap, for when the couple finally becomes aware of the possibility that the transfer might have been a gift, it is almost always too late for a timely return. To constitute the noncontributing spouse as an owner then would require a gift of the entire one-half interest. Appreciation and inflation aggravate the problem since current fair market value would be involved in a transfer at termination of the joint interest. If that value is higher, and if the termination would involve a transfer of an asset acquired by gradual payments over a period of time, the gift tax consequences can be very severe.

As an example, consider a house bought with a purchase price of $50,000 and a $10,000 down payment. Mortgage payments in annual increments are made. Had elections been made on timely gift tax returns to treat the down payment and annual mortgage payment as gifts, little if any of the exemption equivalent to the credit against the unified gift and estate tax would be used. On the other hand, if the elections are not made and if a severance is effected on a scale with each spouse receiving one-half of the proceeds and the appreciated value is $250,000, the consequence is a $125,000 gift (of which $25,000 is in excess of the gift tax marital deduction) by the contributing spouse to the noncontributing spouse. This can be very disadvantageous in many situations.

A relatively simple statutory change to permit the election to be made on a return, whether timely or not, would relieve the situation. It is particularly pertinent if the suggested Section 2515 change is made, for nonrealty transfers are virtually handled in this fashion now. Acquisition of a security in joint form under existing law involves a gift. The tax now remains due, based on fair market value at acquisition, under today's law, and can and should be paid on a return, whether timely or not. The taxable event was acquisition, an not anything subsequent. What is being urged here for expanded Section 2515 is that acquisition remain the taxable event, with the election available to treat the transfer as a gift at any time after acquisition. In essence, the question of gift or no gift would remain open until the spouses close the transaction, but, when it is closed, the closure would relate back to acquisition cost and would not require a fair market value transfer at the date of closure.

11. *Joint property at death.*—If section 2056 is amended to permit the quantitative expansion of the marital deduction this will end many of the problems with respect to joint tenancy property between spouses at death. However, should the Congress

not be willing to go as far as to permit the unlimited quantitative expansion of the marital deduction, then Section 2040 should be amended so that at death only half of the property held in any form of joint ownership between spouses would be taxed in the estate of each spouse, without the need for tracing. The complex rules enacted in the 1976 Tax Reform Act and 1978 Revenue Act, introducing the new concepts of qualified joint tenancy and related problems should all be repealed. But any property held in joint ownership for which no gift tax has been paid at the creation of the joint tenancy should be removed from the adjusted gross estate in figuring the base on which the marital deduction is computed at death. This is the present approach to community property.

12. *The unlimited marital deduction.*—Dissatisfaction with the marital deduction stems from these concerns: First, it does not achieve complete equality of tax treatment as between community and non-community property states because the marital deduction for lifetime transfers is limited to 50 percent of the value of each gift to the donee spouse after the initial $100,000 deduction and the non-deductible second $100,000.[6] Second, it still results in the imposition of a transfer tax or at least the impairment of the exemption on the movement of property from spouse to spouse and forces them into an unnatural record-keeping of interspousal transfers if there is to be compliance with the law. Third, frequently the tax that has to be paid as a result of an interspousal transfer comes at the death of a spouse, a time when significant sources of income may disappear, and hence not a time when a further economic adjustment should be required to pay taxes on the transfer. Fourth, unnecessary complex distortions are necessary to give the surviving spouse on the donor spouse's death the optimum marital deduction to avoid overqualifying and the unnecessary pyramiding tax in the surviving spouse's estate (an interrelationship exists with the exemption equivalent to the unified credit, other credits and the generation-skipping transfer tax); and Fifth, in smaller estates, the 50 percent marital deduction is frequently inadequate to provide the surviving spouse with an adequate tax-free amount

A 100 percent marital deduction with no disqualification of community property would eliminate all the concerns mentioned in regard to the present marital deduction and bring to full fruition from a tax standpoint the often expressed attitude of husband and wife that the property is "ours," without regard to the technical legal ownership requirements.

Under present law the unified gift and estate tax rates might be built up by lifetime transfers to persons other than the donor's spouse to the point where adequate provisions could not be made for the spouse at death out of what would be left after the tax bite. This danger did not exist to the same degree under the pre-1977 dual tax system because no matter how extensive the lifetime transfers were a fresh start at the bottom of the estate tax schedule was available to the 50 percent that could not qualify under a 50 percent limitation on the maximum marital deduction.

A 100 percent marital deduction makes it possible in passing property on to others to take full advantage of the bottom transfer tax brackets of both spouses. Even though all the property is owned by one spouse, the donor spouse can pass one half over to the donee spouse without any tax, and the donee spouse can give half of that half away in her lifetime and the other half on her death, and the donor spouse can do likewise. This results in only two bottom rate schedules being utilized.

Adoption of the 100 percent marital deduction would cause some revenue loss. According to Appendix C to the American Law Institute 1968 Reporter's Study at page 410, in the long run the revenue would be about 7 percent less than with the pre-1976 50 percent marital deduction.

13. *Extension of the credit for prior transfers.*—If the donee-spouse dies first, half of the property will be included in her or his estate, and the entire property will subsequently be included in the donor-spouse's estate. This is a problem that generally exists where gifts are made to a spouse. It can be alleviated by an extension of the existing credit for property previously taxed in the estate of one spouse, with the elimination of the present ten-year limit and the 20 percent credit decrease that occurs every two years. This specially extended credit rule for property previously taxed in inter-spousal transfers would permit a 100 percent undiminished credit, regardless of the number of years between the death of the spouses.

The unfortunate whipsaw consequences of the same property being included in the estates of two decedents (usually spouses) could be solved by extending the

[6] Under community property laws half a husband's accumulated earnings, for example, will become his wife's without any taxable transfer, and will thus be removed from his taxable estate even if the wife is the first to die. In a common law state the husband would be left with all the accumulated earnings taxable in his estate, if he survives, unless he had made gifts to his wife before her death.

mitigation of the statute of limitations provisions in Sections 1311 through 1315 into the estate tax area. These provisions deal with inconsistent income tax determinations that either give the government or the taxpayer an unfair advantage which cannot be rectified because of the running of the statute of limitations. The provisions permit the reopening of the statute of limitations under certain conditions in the interest of fairness. However, they are quite complex and the extension of them to the federal estate tax will add further complexity to them. The same objective can be accomplished through the use of the above-described 100 percent credit for tax on prior transfers between spouses.

14. *Qualitative-expansion of the marital deduction and elimination of the terminable interest rule.*—The marital deduction should be available for any full income interest passing to the surviving spouse, regardless of whether there is a general power of appointment accompanying it. In other words, any transfer which provides the donee-spouse with the current beneficial enjoyment of community or separate property should qualify to the extent of the full value of the property. In the case of income-producing property, current beneficial enjoyment means the right to receive the income. Thus, a transfer in trust with directions to pay the income to the donor's wife for life, with remainder over to designated beneficiaries and with no power in the wife to change the destination of the property on her death would qualify for the marital deduction under this current-beneficial-enjoyment test. This type of trust can be used where the donor-spouse wants to protect his children from being left out as a result, for example, of the second marriage of his spouse.

Deductibility would be available in the first estate, provided that the interest is to be included in the second one. Furthermore, the surviving spouse should be allowed either to accept or reject the marital deduction tax result in the qualifying limited interest situation, such as where he or she receives only a life estate. Thus, in effect, the surviving spouse would have an option to prepay the death taxes when there is a straight life estate, but still receive the life estate.

In essence, the Section 2056 terminable interest rule would be abolished in the interest of simplicity, to make it easier for the non-specialist to avoid problems and to avoid the whipsaw effect of the inconsistency involved in requiring inclusion in the survivor's estate in situations where the marital deduction is not always available in the estate of the first spouse. This is illustrated by cases involving overly broad powers to allocate between principal and income or to retain unproductive assets, so that not all the income requirements for a marital deduction power of appointment trust are met and cases where the power of appointment does not qualify as a general power of appointment under Section 2056 but nonetheless falls within the Section 2041 definition of a general power of appointment. Another example of cases which would be ameliorated by this change are those where there is disallowance of the deduction in the first estate because of a requirement of survivorship running beyond the allowable six-month period which actually is satisified so that the property does in fact pass to the surviving spouse and is taxed in the second estate.

Perhaps the worst aspect of the present requirements is the compulsion they place upon a property owner. He must do something with his property that he might not otherwise wish to do. While he may be perfectly willing to provide for his spouse, he may not want to do this in a way that allows that spouse to divert the property from his children after his death. These fears may involve a concern over the surviving spouse's remarriage or where a donor has a family by a predeceased first spouse and then remarries leading to the fear that the second spouse will not make adequate provision for the children of the first marriage. To mitigate this situation, a limited interest should be allowed to qualify for the marital deduction.

If the decedent's spouse leaves the surviving spouse an interest which will cause the property to be includible in the survivor's estate upon death, that fact alone ought to be sufficient for a qualifying gift. For example, if the survivor accepts broad benefits, such a general power of appointment or outright ownership of the property, then the first estate is allowed a deduction, because the survivor has that quantum of ownership which requires estate taxation when he or she later dies. That rather parallels the present marital deduction, except that it substitutes for the technical terminable interest rules a basic rule which simply and directly states that the interest qualifies if the surviving spouse takes such an interest as would cause inclusion in the surviving spouse's estate if retained until death (which, of course, also means that, if the survivor disposes of it before death, it is subject to the gift tax).

A further recommendation is that the spouse dying first should be able to tender to the second spouse a terminable interest which qualifies, if the first spouse to die declares a desire to have that interest qualify. Thus, in the classic case of a life estate for a wife, with remainder over to whomever her husband specified in the instrument, if the widow accepts this tender, it should be deductible in her husband's estate and her acceptance of it as a marital deduction gift will constitute a stipulation that it will be includible in her estate when she later dies. Unless her husband expressly conditions this bequest on her acceptance of it as a marital deduction bequest, however, she could take the property rights but decline the tax consequences through post-mortem planning and prepay the tax by declining to take it as a marital deduction gift. She could still have the right to the income (she need not forfeit her rights under the will) but she only declines to take it as a marital deduction gift.

Protection of the husband's other beneficiaries is important in such a situation. This could be accomplished by having the additional tax caused by this unanticipated enlargement of his taxable estate borne specifically by the assets which caused that enlargement, that is, the assets tendered but rejected for the marital deduction. Of course, the husband may include an apportionment clause to the contrary, but Sections similar to the tax apportionment for life insurance under 2205 and powers of appointment under 2207 should be put into the Code to deal with the unplanned situations.

These proposed changes should not cause a significant loss of revenue, but would give more more flexibility to estate planning, particularly at the post-mortem stage; the election could actually result in particular cases in revenue advantages because of prepaying of taxes that would otherwise not be due until the wife's death. This election, however, would most likely be used in cases where it would be advantageous from a rate viewpoint. In any event, where it does reduce the tax, it does so by removing an inequity rather than creating one.

The introduction of current-beneficial-enjoyment test, allowing a qualitative expansion of the marital deduction and the accompanying elimination of the terminable-interest rule might be said to give the common law states some advantage over the community property states, in that in the latter the surviving spouse will end up owning outright, with full control, one-half of the community property, whereas in a common law state the same tax benefit can be produced by giving the surviving spouse only a life interest. This is true, but even in a community property state the deceased spouse's half of the community property could also be qualified for the marital deduction by giving the surviving spouse only a life interest therein. Moreover, it owuld be possible in a community property state, if one spouse can transfer his share of the community property to the other, for a spouse to transfer his share of the community property to the other spouse without any transfer tax cost and then the receiving spouse could deal with the entire property in the same way as in a common law state.

As previously mentioned, if terminable interests qualify for the marital deduction, then a transfer would be considered to be made by the donee-spouse whenever the current beneficial enjoyment ceases. This will be on her death, if she is given a life interest, but may be prior to her death if she is given a current interest until she remarries or for some stated period of time. The property she is treated as transferring on the termination of her current beneficial enjoyment may pass to predetermined beneficiaries. It would not be fair to her to subject her other assets to the payment of the tax assessed on this imputed transfer. Furthermore, the tax on this transfer should be at the top rate for the taxable period involved, so that the tax on other assets transferred by her in such period is not higher than it otherwise would be. Insofar as deathtime transfers are concerned, this will mean the imputed transfers will always be taxed at the donee spouse's ultimate top rate. Insofar as lifetime transfers are concerned, however, an imputed transfer in one taxable period, though at the top rate for that period, would affect the beginning rate applicable to transfers in a future period, unless some special rule is adopted to cover this situation. In the usual case, the imputed transfer will not occur prior to death. In the instances where it does, one possibility would be to tax the imputed transfer at what would be the top rate if all the property then owned by the wife were transferred, and to ignore the value of the imputed transfer in determining the rate which other transfers are taxed.

15. *Election as to time of imposition of tax.*—Under the present marital deduction, there is no election available to pay the tax on a qualified marital deduction gift at the time of the transfer and eliminate from transfer taxation the movement of the beneficial enjoyment out of the donee-spouse. Somewhat the same end may be accomplished by giving the donee-spouse a benefit that does not qualify for the marital deduction and under which she will not be regarded as the owner for transfer tax purposes. If a change is made to a current-beneficial-enjoyment test, the area of qualified marital deduction gifts will expand tremendously. An election should therefore be given to treat a qualified marital deduction gift as subject to the transfer tax at the time it is made with provision that no transfer tax would then be

imposed on the termination of the donee-spouse's current beneficial enjoyment. This would mean that if the entire current benefit were conferred on the donee-spouse in the form of life interest, one-half could be taxed at the donor-spouse's death and the other half at the donee-spouse's death (or any other fractional division), if that appeared desirable in the particular case. Also, the donee-spouse could be given the outright ownership of property and an election made to pay a tax thereon (or on some part) at the time of the donor spouse's transfer and, if the property on which the tax had been paid could be traced, no tax would be payable on its transfer by the donee-spouse.

16. *Analysis of the proposed expansion of the marital deduction.*—The major problem with a complete exemption from tax for transfers to a spouse is that these would be at the expense of transfers to other members of the transferor's family. When the spouse will need all of the income to live on—as will usually be the case with the small and medium sized estate—this result should not have an adverse effect. However, in the case of a large estate, where the income is more than sufficient to satisfy the spouse's needs, the tax "pull" of avoiding all tax may lead to unwise dispositions ignoring other family members, at least until after the spouse's death. A shift to a current beneficial enjoyment theory (qualitative expansion) for marital deduction qualification would ameliorate this situation, particularly in cases of second marriages and children by a first marriage, by permitting the first spouse to die to control the disposition of the property after the surviving spouse's death. Nevertheless, the problem will to some extent remain. Another problem is that when a part of the estate is more than sufficient to satisfy the spouse's needs a question arises as to whether postponement of the collection of all tax as a result of an unlimited marital deduction should be permitted. These two problems could be dealt with by putting a ceiling of one or two million dollars on the quantitative expansion of the marital deduction.

C. Liquidity Problems

One of the most important problems in the federal estate tax area involves the illiquid estate, whose principal asset is a farm or closely-held family business or even some other asset the forced sale of which would cause considerable hardship. These problems can arise as a result of improper estate planning, rapid appreciation in the value of an asset, or reluctance to sell an asset for sentimental or business reasons. The inability to pay death taxes in a timely fashion is referred to as the "liquidity problem".

Careful business and estate planning can help to eliminate the liquidity problem. Moreover, the tax laws already provide installment payment privileges for use in situations in which an estate contains a farm or other closely-held business. However, experience has shown that these installment payment privileges are not liberal enough and certain other provisions of the Internal Revenue Code create barriers to the use of those privileges.

The special use valuation rules of Section 2032A were enacted in 1976 to give special treatment to farms and closely-held business real estate, by permitting them to be valued on the basis of their actual rather than potential use.

The problem with these special use valuation rules is that they violate the criteria of neutrality, uniformity and equity, while adding substantial complexity to the planning and administration of estates with this type of property in an attempt to avoid creating new estate tax shelters. On the other hand, they fail to cope with the problems experienced by most other illiquid estates without these assets. While these rules have found acceptance by many farmers and their tax advisors, the Internal Revenue Service has administered them in such a technical and hostile manner that the Congressional objectives in enacting them have been largely frustrated.

Two alternate approaches can be taken in this area. One would be to make technical improvements and simplify the operation of the rules, making it clear to the Treasury that their administration is not to be handled in such a way as to frustrate their underlying legislative policy. The other approach would be to replace the special use valuation concept entirely, repealing Section 2032A and related statutory complexities. This should only be done if the farm organizations are satisfied that farmers would be better off under a different system providing greater relief for all illiquid estates and closely-held businesses, relieving their hardships by establishing rules that set more liberal and objective standards in granting extensions for payment of federal estate taxes, coupled with a phased in forgiveness of a portion of the taxes owed by qualifying farms and closely-held businesses (whether or not the latter own real estate) if their operation continues to remain in the hands of the family.

It is expected that the proposal to allow an unlimited marital deduction will substantially ease liquidity problems by postponing the death taxes which would otherwise be payable on assets transferred to a surviving spouse. This will give the surviving spouse more time to plan for the disposition of an illiquid asset at the best possible price or, alternatively, more time to accomplish business and estate planning to insure the availability of funds when death taxes eventually become due with respect to the asset. Moreover, the unlimited marital deduction will help to insure the security of a surviving widow, because it will not usually be necessary to raise funds to pay taxes with respect to a family farm or business until after the death of the widow herself. It is expected that these benefits will be of special help in connection with estates of moderate size.

In addition, a reduction of transfer tax rates will help to ease liquidity problems, by lowering the amount of tax due with respect to any given asset.

Besides the proposals outlined above, which will generally assist all estates, specific proposals are contained here which are designed to ease liquidity problems in the case of estates containing farms and closely-held businesses. Additional relief in these cases seems appropriate, because such estates tend to encounter more severe liquidity problems than do estates containing other types of assets. There specific proposals are:

To make further changes in present rules to make it easier for estates containing farms or other closely-held businesses to qualify for installment payment of death taxes over periods of up to 20 years.

Executors, and certain fiduciaries should be able to obtain a discharge from personal liability for taxes on illiquid assets, when the time for payment of those taxes has been extended, provided that the executor or fiduciary pays those taxes which are not subject to the extension and furnishes adequate security for payment of the remaining taxes. In general, subject to normal business safeguards, a security interest in the illiquid asset will constitute adequate security in such cases. Accordingly, the Government should not only permit deferral of taxes, but should bear part of the risk that the illiquid asset may decline in value during the deferral period.

Executors should be permitted to enter into security agreements, in lieu of bonds, when extensions of time for payments of taxes are requested. A modified bonding requirement would be retained for use in those situations in which the security agreement provisions are not utilized. In general, the security agreements permitted would resemble those authorized by State law under the Uniform Commercial Code.

Additional time should be provided for making redemptions of closely-held business stock at capital gains rates to pay death taxes attributable to the inclusion of that stock in the gross estate.

These specific relief provisions, taken together, should make it possible for the owners of any viable farming operation or closely-held business to generate the resources needed to pay the death taxes and estate settlement costs which become due at the time of death with respect to such assets.

1. *Broaden definitions of closely-held business eligible for deferred payment of estate tax.*—(a) The deferral sections: Section 6166A permits installment payments of estate taxes attributable to a farm or closely-held business for up to ten years (if the value of the business or farm exceeds either 35 percent of the gross estate or 50 percent of the taxable éstate). Broadly speaking, it defines a closely-held business as one in which 20 percent of the value of the business is in the decedent's estate or in which there are 15 or fewer partners or shareholders.

Section 6166 has a more liberal extended payout alternative where the value of a closely-held business exceeds 65 percent of the adjusted gross estate. If so, the executor can elect to pay interest only on the tax due for the first five years, followed by paying tax liability in ten yearly installments thereafter, with a special interest rate of 4 percent on the estate tax attributable to the first one million dollars of closely-held business property and the regular rate (now 12 percent) applicable to the excess. But all of the deferred tax may be accelerated if one-third or more of the business is disposed of, as contrasted with a disposition of half or more causing acceleration of the tax under Section 6166A.

These two alternative sections are somewhat redundant and the most liberal features of both should be combined and further liberalized, as more particularly set forth below. In addition, if the farm organizations are agreeable, in lieu of the special use valuation rules applicable to qualifying farms and closely-held business real estate where the decedent or his family have "materially participated" in the operation of the farm or business for five of the eight years prior to death and the property passes to a qualified heir (spouse, children and other close relatives), for each year that the farm or closely-held business is retained by the heir and used for farming or other closely-held business purposes, one fifteenth of the tax due with respect to the property in the gross estate comprising the farm or other closely-held business interest should be forgiven; the tax forgiveness to be coordinated with the recommendations for liberalization of the Section 6166 and 6166A extended payout provisions. There should be no material participation requirement in order to have the farm or other closely-held business eligible for the phased in forgiveness and extended payout requirements. (Senator Wallop's bill, S. 1984 proposes repeal of the material participation requirement with respect to the special use valuation rules, since many commentators have been critical of the restrictive character of this requirement.)

The phased in 15 year tax forgiveness provisions recommended above as a replacement for the special use valuation rules would greatly simplify estate administration of farms and closely-held businesses, since there would be no need for a recapture tax, no more concern over material participation or over the other problems created by the complexities of the special use valuation rules.

The definition of an interest in a closely-held business should be broadened to deal with situations in which an estate may be unable to pay the tax because its assets consist substantially of an interest in a farm or unliquid business which does not meet the present tests. Thus the definition of a closely-held business should include a business 20 percent or more of the value of which (or of the voting stock of which) was owned either actually or constructively by the decedent, or the stock of which was not traded on an exchange or in the over-the-counter market. This would expand the definition of closely-held businesses to cover nearly all cases where the shares of a corporation may not be readily sold at their approximate fair market value.

Constructive ownership rules attributing to the estate stock owned by siblings, lineals and spouses should be applied. These would extend the Section 6166 treatment to those situations where the estate owns less than 20 percent of the business but, for practical purposes, the estate is no more liquid than if it owned more. This is because diffusion of ownership among family members is unlikely by itself to result in diminution of the liquidity problem, particularly because of the difficulty in selling a minority interest in a closely-held business to an unrelated third party where other important shareholders are members of a single family. The tests of 35 percent of the gross estate or 50 percent of the taxable estate should be replaced by a requirement that the business be only 20 percent of the gross estate or 25 percent of the taxable estate.

The alternative definition of a closely-held corporation—that it have fifteen or less shareholders—should be replaced by a test as to whether or not the stock is traded on a securities exchange or in the over-the-counter market, since this really deals with whether the estate is in a position to liquidate its shares, regardless of the number of stockholders. Similarly, the requirement that there be fifteen or less partners should be liberalized (for partnerships) so long as the 20 percent test remains.

(b) Withdrawal and acceleration: Another serious problem for the illiquid estate for which a deferral has been obtained may arise because a withdrawal from or a disposition of the interest in the business can, under certain circumstances, cause acceleration of the remaining installments of the estate tax, without providing the estate with sufficient liquid assets with which to pay it.

Section 6166A(h)(1)(A) and 6166(g)(1)(A) respectively provide in substance that, if withdrawals from the closely-held business equal or exceed 50 or 33⅓ percent or more of the closely-held business is sold or exchanged, the payment of the remaining federal estate tax is accelerated.

There appears to be no justification for an acceleration of the federal estate tax regardless of the percentage of the closely-held business which is either withdrawn or sold, so long as the withdrawal or sales proceeds are applied substantially to pay the remaining estate tax due, and, in fact, the statute provides for exceptions in the case of a sale or exchange, where the proceeds are used entirely for the payment of federal estate tax. But not all of the proceeds should have to be applied against the federal estate tax to prevent an acceleration of estate tax payments. Some of these proceeds will be needed to pay state death (taxes or other debts) which fall due during the period of the estate tax installment payouts.

If Section 6166 required all of the withdrawn funds or sales proceeds to be applied to the federal estate tax, the executor who used such funds or such proceeds to pay state death taxes and other debts would then have to borrow an equal amount of funds to use for the federal estate tax at the next installment due date. This hardly helps to alleviate the monetary problems of the illiquid estate. The exception to accelerate should apply if at least half of the proceeds are used to pay the federal estate tax.

A similar problem arises under Section 6166(g)(1)(B) and 6166(h)(1)(B). These make an exception from the general acceleration provision where there is a distribution in redemption of stock under Section 303. The last paragraph of subparagraph (B) of both of these sections provides that the exceptions will only apply if an amount of the estate tax not less than the redemption distribution is applied on the next installment of the federal estate tax. This requirement that the entire distribution be applied against the federal estate tax causes the same liquidity problem noted above, namely, that where a distribution is necessary to pay the state death taxes or other pressing debts, it is then necessary for the executor to thereafter borrow the same amount of funds to apply against the federal estate tax, thereby compounding his illiquidity problems. Again it is recommended that only a portion of the redemption distribution, such as half of it, be required to be paid on the federal estate tax at the time the next installment is due.

Also, a "disposition" under Sections 6166(G)(1)(A)(i) and 6166(h)(1)(A)(ii) and a "distribution under their subparagraphs (B) should be so defined that, when notes are received in exchange for the corporate stock, the "disposition" or "distribution" would be deemed to occur only when payments are made on the notes or the notes are pledged for a loan.

2. *Set objective standards for reasonable cause for deferring payment of tax, and extend the period to 20 years.*—In addition to providing for more liberal relief through permitting installment payment of estate tax over a period of years to be available to a broader class of farms and closely-held businesses, the ten-year extension under Section 6161(a)(2) (permitted whenever a fiduciary can show reasonable cause for his inability to pay the estate tax when due) should be available on an objective basis, rather than giving the Internal Revenue Service discretion to grant this privilege only if an examination of all the facts and circumstances discloses that a request for an extension of up to a year is based upon reasonable cause. This extension should be for up to twenty years.

The Senate Finance Committee Report to the Excise, Estate and Gift Tax Adjustment Act of 1970, gives six examples in which there would be reasonable cause for an extension:

The first example involves situations where farms or closely-held businesses comprise a significant portion of an estate, but not enough to satisfy the percentage requirements for obtaining a Section 6166(a) extension. Although these interests could be sold to unrelating persons for their fair market value to obtain funds to pay the estate tax, the executor could raise the funds from other sources if he had more time.

The second example deals with an estate of sufficient liquid assets to pay the tax when otherwise due, where the assets were located in several jurisdictions and not immediately subject to control of the executor, so he cannot readily marshal them.

The third example is of an estate a substantial part of whose assets consist of rights to future payments (annuities copyright royalties, contingent fees or accounts receivable), where there is insufficient cash with which to pay the estate tax when otherwise due and a loan cannot be obtained, except upon terms inflicting loss upon the estate.

In the fourth example, the estate includes a claim to substantial assets which cannot be collected without litigation, so that the size of the gross estate is unascertainable as of the time the tax is otherwise due.

The fifth example deals with assets must be liquidated at a sacrifice price or in a depressed market, to pay the estate tax when otherwise due.

In the sixth example, the estate has insufficient funds (without borrowing at a higher rate of interest than that generally available) to pay the entire estate tax when otherwise due, provide a reasonable allowance for the family during the remaining period of administration and satisfy claims against the estate. The executor has made a reasonable effort to convert assets in his possession to cash (other than an interest in a closely-held business to which Section 6166 applies).

In all six of these cases, an extension of time to pay the tax for up to twenty years should be automatically granted upon representation of the existence of the problem in a sworn affidavit from the executor. This would still leave to the discretion of the Internal Revenue Service other cases where an examination of the facts and circumstances discloses that a request for an extension for up to twenty years (presently ten years) is reasonable. However, in these other cases, the Code should require the Commissioner to grant such an extension unless he determines that there is reasonable cause not to grant one. Should it later become apparent that the taxpayer submitted false or insufficient information, existing civil and criminal penalties are adequate to deal with that problem.

3. *Lengthen the maximum extension to 20 years.*—The present maximum period for obtaining extension of time to pay estate tax under Section 6161 and 6161A is ten years and it is fifteen years under Section 6166, but an extension under Sections 6166 and 6166A must be elected at the time the return is filed. This election should also be available if a deficiency is assessed and, furthermore, installment payments

of the tax under the conditions described in both Sections 6161 and 6166 should be permitted for up to twenty years.

4. *Reduce interest rate on extensions to half of that currently prescribed.*—In all cases where payment of the estate tax is to be deferred under Section 6161, 6163 (dealing with extensions for the payment of estate tax attributable to a future interest), 6166 and 6166A, the interest should be reduced to half of the rate currently prescribed. For many years, until 1975, interest was imposed at only 4 percent rate on extensions of time for undue hardship (Section 6161(a)(2)), because of a future interest (Section 6163), or where there was a closely-held business in the estate (Section 6166), although the regular six percent interest rate applied to twelve-month extensions under Section 6161(a)(1). The 4 percent rate now applies only to the tax on the first million dollars of farm or closely-held business property under Section 6166.

Effective June 30, 1975, the preferential rate of interest was abolished at the same time that interest rates were raised to 9 percent (now 12 percent, at least until February 1, 1982). The Senate Finance Committee explanation of the change that eliminated the preferential interest rate overlooked the fact that estates holding closely-held businesses and other illiquid assets must not only earn profits to pay the interest charge, but also to pay the unpaid installment of estate tax. It would further the purposes of the extension provisions as originally enacted and the liberalizations as proposed to reinstate a preferential interest rate which would rise and fall in proportion to the current rate of interest for income tax purposes. (For the next two years at least, this would be 2 percent higher than the preferential rate available under Section 6166.)

Adoption of the above proposals would go a long way to solve most liquidity problems experienced by estates. From the standpoint of sound tax policy, the uniform application of these provisions, regardless of the nature of the illiquid assets, would further the objectives of neutrality, equity, and uniformity of application of the estate tax laws, as well as providing certainty that relief would be available in most cases.

5. *Create an extended alternate valuation date for hard to value assets.*—Great difficulties are created for estates holding hard to value assets and for the Internal Revenue Service in dealing with these assets. Current rules require appraisals which can be expensive, can result in costly and time consuming controversies with the Internal Revenue Service, and may result in unfairness to one side or the other when assets are sold within a reasonable period after death. Therefore (besides a recommendation made later in this statement to set the alternate valuation date at one year), it is recommended that where an estate holds assets described in Section 6161(a)(1), 6166 or 6166A or real estate or tangible personal property (other than property which depreciates in value due to the lapse of time or normal use—such as the family car) at the time of filing of the return, the executor should be permitted to elect a deferred alternate valuation date for such property (separate from the normal election with respect to valuation dates) which would permit the valuation of these assets to be postponed for a period of up to three years following the date of the filing of the estate tax return, with valuation to be fixed by actual sale or, if none, by appraisal at the end of the period. Needless to say, unless otherwise deferrable, the federal estate tax attributable to these illiquid assets should be paid on an estimated basis and there should be a tolling of the limitations as applied to questions affecting these assets.

6. *Revision of Section 6165.*—Under existing Section 6165, District Directors may require, as a precondition to the granting of an extension of time to pay taxes, and the taxpayer furnish a bond for up to double the amount with respect to which an extension is granted. Administrative practice under Section 6165 varies widely and the procedure may be expensive to taxpayers.

It is proposed that Section 6165 be revised to permit the use of security arrangements, in lieu of bonds, when extensions of time for payment of taxes are requested. The bonding requirement would be retained for use in those situations in which a satisfactory security agreement is not furnished. The bond would be in the amount of unpaid tax, plus any anticipated additions thereto, including the interest which may reasonably be expected to accrue on the unpaid tax during the extension of time for payment.

The major proposed revision in Section 6165 would authorize use of security arrangements such as mortgages, pledges, and escrow agreements, in lieu of bonds. The precise form of security interest which will be required in a specific situation should be left to the discretion of the District Director. These provisions would also establish the method of creating security interests in property in accordance with the terms of a security agreement, the furnishing of collateral which is to be subject to these security interests, the standards for determining the necessary amount of collateral, the way in which security agreements become effective, the method of terminating security agreements and interests, and the rights of the District Director in the event of default in payment of taxes. These proposed provisions of Section 6165 follow the basic pattern and terminology established by the Uniform Commercial Code, which has now been adopted in a majority of the States.

In determining the amount of collateral to be furnished to secure the payment of taxes when an extension of time has been granted under Sections 6166 or 6166A, Section 6165 should provide that the decedent's interest in a closely-held business (including farms) shall, in all cases, constitute adequate collateral to secure the payment of taxes imposed with respect to that business interest. Such collateral will normally be adequate to secure the Government's interest, since the tax with respect to a closely-held asset will always be smaller than the value of the asset itself. However, an exception to this rule may be made in situations in which the closely-held business is encumbered by prior liens. In such cases, the District Director may demand enough additional collateral to give reasonable assurance that he will ultimately collect the unpaid tax and any additions thereto.

In instances in which the decedent's closely-held corporate stock has been furnished as collateral subject to a security interest, the District Director will be entitled to all the rights granted to stockholders by local law, including notice of corporate actions which might impair capital. In addition, in order to provide for instances in which local law does not provide adequate safeguards, Section 6165 should specifically provide that the District Director is entitled to 90 days notice of sales of corporate assets of a value greater than $1,000 (other than sales in the ordinary course of business), to notice of the declaration of a dividend, and to notice of any other action calculated to have a substantial effect upon the liquidation value of a firm, including changes in the salaries of officers or directors. Failure to furnish such notice will constitute a default, which will authorize the District Director to enforce his security interests.

7. *Revision of section 2204.*—Section 2204 relieves the executor of personal liability for subsequently determined estate tax deficiencies only in those instances in which the executor pays in full the amount of the estate tax which has already been determined to be due. Consequently, a Section 2204 discharge cannot be obtained when an extension of time to pay estate taxes has been requested. A related problem arises in instances in which trust assets are includible in the estate. In such instances, fiduciaries administering the trust may find themselves liable as transferees for unpaid estate taxes, even though the executor of the estate may have been discharged under the provisions fof Section 2204.

To deal with these problems, Section 2204 should be revised to permit an executor to be discharged from personal liability if two conditions are met. First, the executor must pay all taxes and additions, including deficiencies, which have been assessed prior to the date of discharge and for which no extension of time for payment has been requested. Second, the executor must enter into a Section 6165 security agreement (or furnish an adequate bond in lieu of a security agreement) to assure payment of taxes in those instances in which an extension of time has been requested.

Similar rules should apply to fiduciaries other than executors who hold assets which are includible in the gross estate. If such a fiduciary makes a timely application for a certificate of discharge from personal liability for unpaid estate taxes, and if the executor fulfills the two conditions outlined above, the fiduciary should also be relieved from personal liability for those taxes.

Another minor change which could be made in Section 2204 would give the Service up to 18 months from the date of filing of an estate tax return, to issue a certificate of discharge to an executor or other fiduciary. This conforms with the Service's normal estate tax audit cycle.

8. *Section 303 revisions.*—Under present law, capital gains treatment is accorded to certain redemptions of corporate stock to pay death taxes, funeral and administration expenses. In order to qualify for this favorable treatment, the redemption must be accomplished by a corporation whose stock comprises more than 50% of the value of the decedent's adjusted gross estate.

It is proposed that Section 303 be revised to conform to the proposed revised provisions of Sections 6166 and 6166A. Section 303 redemption should be permitted to extend over a period of 20 years—but the use of notes or similar devises to avoid these time limitations would be ended. Thus, the maximum time period for Section 303 redemptions would match the 20 year maximum time period for payment of taxes set forth in proposed Sections 6166 and 6166A.

D. Transfers-for-consumption and the inadequacy of the $3,000 present interest gift tax exclusion

Two major problems are becoming increasingly serious in the area of inter vivos transfers to people other than the spouse of the donor. One of these is caused by the common misunderstanding about the gift tax consequences of providing financial assistance to family members and others where the funds provided are not considered support. The average person does not realize that there may be liability for filing a gift tax return and an impairment of the exemption equivalent to the credit against the unified gift and estate taxes if he provides a child with educational benefits beyond those legally required or if he pays the medical bills of a sick relative and these exceed $3,000 a year for any one person.

While it is clear that the use of funds to discharge a legal obligation of support does not involve a taxable gift, a second problem arises because expenditures deemed to discharge a legal obligation to support another person are determined on the basis of local law, which is neither uniform nor clear in this area. Thus, to the extent that freedom from gift tax liability is founded on the legal-obligation test, the federal gift tax (or more accurately the requirement to file a gift tax return and impair the unified credit) is imposed on some and not on others in identical circumstances, solely because of a difference in applicable local law.

Both problems have been compounded by the continuing and ever accelerating rate of inflation while the gift tax annual exclusion of $3,000 has not been changed since it was reduced to that figure in 1942, after originally being set at $5,000 in 1932. At the time the exclusion was cut to $3,000, this was believed to be sufficient to take care of most birthday, Christmas and anniversary gifts, while the problem of transfers for consumption was not a serious one then. As a matter of fact, the widespread adoption of the reduction of the age of majority from 21 to 18, coupled with the elimination of a requirement to support children over 18 in many states, has further aggravated the transfer for consumption problem during the last ten years.

Therefore, not only should the present gift tax annual exclusion be increased to a figure more in line with the depreciation of the dollar over the last 38 years (possibly to $10,000), but in addition various so-called "transfers for consumption" should be excluded from the gift tax base, without regard to whether they in fact involve a discharge of a legal obligation to support a dependent. This will tend to eliminate the significance of the differences in local law as to what constitutes a legal obligation to support another, and thus promote equity by applying the tax laws in substantially the same way in all states. At the same time, the increase in the gift tax annual exclusion will restore what the latter has lost to inflation over the years. The basis problem is responding to normal family instincts with respect to intra-family transfers of property and preventing these shiftings of property interests from affecting the beginning rate applicable to death-time transfers.

The "transfer-for-consumption" proposal has no significance so far as transfers-for-consumption between spouses are concerned if the unlimited marital deduction is adopted. If this unlimited marital deduction is not adopted, then the transfer-for-consumption proposal should apply to interspousal transfers, too.

The proposal with respect to transfers-for-consumption should apply only to lifetime transfers, since the underlying policy of the proposal does not carry over significantly to death-time dispositions, in the same manner that the annual per donee exclusion is not available with respect to death-time transfers.

While a "transfer-for-consumption" exception may raise some difficult factual issues in borderline situations, in most cases a transfer will fall clearly on one side of the line or the other. The creation of the difficult borderline area is justified to accomplish the larger benefit of excluding typical transfers that are motivated by considerations other than the buildup of wealth in the transferee. When such a transfer occurs it should, of course, be immaterial whether the payment is made on behalf of the transferee. When such a transfer occurs it should, of course, be immaterial whether the payment is made on behalf of the transferee or to the transferee for the designated purpose.

It is recommended that an expenditure should be excluded from the gift tax if it is for the benefit of any person residing in the donor's household, for the benefit of a child of the donor under 21 years of age or who is a full time student (defined under Section 151(e)(4) as in attendance as such at an educational institution during each of five calendar months) whether or not he resides in the donor's household, provided that the expenditure does not result in the recipient acquiring property which will retain significant value after the elapse of a year from the date of the expenditure. An additional exclusion should be available for the current educational, medical, dental or related costs of any person or the current costs of food, clothing and maintenance of living accomodations of any person who is in fact wholly or partially dependent on the donor for support, provided the expenditure is reasonable in amount under a facts and circumstances test.[7]

E. The completed versus uncompleted gift problem

(Internal Revenue Code Secs. 2012, 2035, 2036, 2037 and 2038.) Under present law, a lifetime arrangement with respect to property may or may not be a completed gift for gift tax purposes. Moreover, even though the arrangement involves a completed gift for gift tax purposes, it may not remove the value of the property from the donor's gross estate for estate tax purposes. This treatment of such completed lifetime gifts—in other words, the area of double transfer taxation—has been thought to be necessary to prevent lifetime transfers that have some of the characteristics of a death-time transfer from escaping the higher estate tax rate schedule. the gift tax paid on these transfers that are also subject to estate taxation will give rise to a credit against the estate tax assessed on the same transfer (I.R.C. Sec. 2012).

It is proposed to eliminate this double taxation area by treating every arrangement as involving either a lifetime transfer or a death-time transfer, but never both. This elimination will simplify the transfer tax structure.

Under the present unified tax, the ultimate tax liability is designed to be approximately the same whether a transfer occurs during life or at death. Hence, the line between lifetime and death-time transfers can be drawn wherever is most convenient. Under the pre-1976 Tax Reform Act dual tax system, on the other hand, it became important not to treat as a lifetime transfer any arrangement with significant testamentary features, because the tax burden on lifetime transfers was generally not an adequate substitute for death taxes.

1. *Retained or granted powers.*—Often a transferor retains (or confers on a trustee or another) power to determine later the ultimate disposition of property transferred by him. In such cases, it is proposed that under a unified tax the existence of a power in a lifetime arrangement should not prevent a transfer from being completed for transfer tax purposes unless (1) the power can be exercised in favor of the transferor, and (2) the power is exercisable by him alone or in conjunction with one who does not have a substantial interest that would be adversely affected by the exercise of power.

The acceptance of this policy in the power cases would result in a completed gift in many cases that would be subject to estate taxes today. It would allow a transferor to retain many strings on a transfer and nevertheless get the value of the future growth out from under transfer taxation, as long as the strings do not permit the transferor to pull the property back to himself.

2. *Retained current beneficial enjoyment.*—It is proposed that a lifetime arrangement under which the transferor retains the current beneficial enjoyment of the transferred property be regarded as an incomplete gift even though the interests of others in the transferred property on the termination of the current beneficial enjoyment are irrevocably fixed. This is a change from present law, under which an irrevocable transfer of property with income retained by the transferor involves a completed gift of the remainder interest for gift tax purposes. The transferred property is also included in the transferor's gross estate for estate tax purposes (I.R.C. Sec. 2036), with a credit for some or all of the gift tax paid (I.R.C. Sec. 2012). In eliminating the double tax area, this transfer has been placed on the uncompleted gift side of the line with the result that it would be taxed as a transfer only at the time the current beneficial enjoyment ends. This would make these arrangements possible without the transferor diminishing his holding by the payment of a transfer tax at the time the arrangement is established.

3. *Retained reversionary interest that is certain to become possessory.*—It is proposed that if the transferor retains a reversionary interest that is certain to become possessory he be treated as making a completed gift of only the interests that precede his reversionary interest. Any interests subsequent to this reversionary interest would be treated as transferred only upon the termination or transfer of the reversionary interest. The retained reversionary interest that is certain to become possessory is close to the retained-current-beneficial-enjoyment case insofar as interests that follow the retained interest are concerned nd the two should be treated similarly.

4. *Employee death benefits.*—It is proposed that any inter vivos arrangement as to the payment of employee death benefits would be on the uncompleted gift side of the line. Such an arrangement is like a transfer with current benefits retained by the employee and should be treated accordingly. The employee death benefit rule

[7] The material and proposals with respect to transfers-for-consumption have been adopted with modifications from the recommendations of the American Law Institute Report on Federal Estate and Gift Taxation (1968).

would apply to any life insurance feature that was a part of an employee benefit plan.

5. *Life insurance.*—Life insurance proceeds are subject to death taxation if the insured retains any incident of ownership. Hence no transfer of a policy should be treated as a completed gift when a tax-significant incident of ownership is retained by the insured, if the double tax area is to be eliminated. If a transferee of some, but less than all, of the tax-significant incidents of ownership exercises an incident given to him to withdraw for his exclusive benefit some of the intrinsic value of the policy, a completed gift of such value should occur at that time because the transferor's incidents of ownership will be destroyed with respect to the amount withdrawn.

6. *Gifts within three years of death.*—A gift of a future interest, a present interest of over $3,000 or any transfer with respect to a life insurance policy within a period of three years before death of the donor results in the value of the transferred property being included in his gross estate under Section 2035. In addition, any gift tax paid with respect to this transfer is also included in the gross estate, with a credit against the estate tax for all or nearly all of the amount paid. This three year rule, which was derived from the pre-1977 rule that transfers within three years of death were presumed to have been made in contemplation of death, is really superfluous (except with respect to gift tax paid on the gift and transfers made with respect to life insurance policies within three years of death) under the unified gift and estate tax system has been in effect since 1976. This is because the gift within three years of death produces no significant advantage to the taxpayer since its value raises the beginning bracket applicable to death-time transfers. On the other hand, retention of this now archaic rule creates a number of complexities in the planning and administration of estates.

Accordingly, it is recommended that except for the amount paid in gift taxes on a lifetime transfer within three years prior to death and transfers with respect to a life insurance policy, the three year rule be abolished.

The above mentioned recommendations with respect to transfers with retained interests and those made within three years of death, if adopted, will go a long way to simplifying the planning and administration of estates and eliminate inconsistent remnants from the old dual transfer tax system. However, as with any changes in rules, the replacement of the rules in Sections 2036 through 2038 with the hard to complete and easy to complete transfer rules will create some uncertainty at the start of their operation, until there has been testing of new concepts in the courts.

F. Revisions and refinements to the taxation of disclaimers

The announced Congressional goals of making major changes to the taxation of disclaimers in the 1976 Tax Reform Act were to achieve uniformity in the application of the tax law to disclaimers as well as to reverse certain case law rules in this area. The second objective was accomplished, the first failed and the present state of the law (even after the 1978 amendments) have left a great many uncertainties and problems in an area where certainty is needed. Unfortunately, the changes affecting the federal taxation of disclaimers since 1976 have not been well thought out, were not coordinated at all with the general trend of state law and have created more problems than they solved, so that most people aware of the situation agree that the present situation is not acceptable.

Possible solutions include exclusive reference to state law, adoption of an American Bar Association legislative recommendation of the American Bar Association recommendation together with an American Law Institute proposal which would both clarify the definition and law with respect to disclaimers and permit the disclaiming party to redirect how the property would pass.

An article prepared by Attorney Thomas W. Wiley, of Phoenix, Arizona, "Disclaimers: A Need for More Reform", presented at the 1980 mid-year meeting of the American College of Probate Counsel, contains a comprehensive treatment of the history, policy and need for reform in the area of disclaimer, including an analysis of the four alternatives and a recommendation that the fourth one be adopted. This article has been reproduced as an appendix to the written statement submitted by J. Thomas Eubank of Houston, Texas.

G. Valuation

Turning to the question of valuation of assets: Wherever there are closely-held business interests or hard to value tangibles, estates are put to a considerable amount of additional expenses and both the estate and the government spend quite a bit of time and money in valuation proceedings. The settlement of estates could be facilitated by improvement of the present valuation methods. For example, Section 2031 presently requires that unlisted and untraded securities have their values determined by considering, along with all other factors, the value of securities of corporations engaged in similar lines of businesses which are listed on an exchange.

The limitation of this comparison to corporations whose securities are listed on an exchange is a technical defect in the law. Accordingly, Section 2031 should be amended to permit comparisons with the securities of other corporations engaged in the same or a similar line of business, regardless of whether their securities are listed on an exchange.

Under regulations promulgated pursuant to Section 2031, tangible personal property is valued at the price at which an item or comparable item could be obtained in the retail market. Thus, replacement value is the criterion for valuation rather than the price obtainable in the market or markets available for the holder of the property being valued. This approach of the Service was rejected by the United States Supreme Court in *United States* v. *Cartwright*, 411 U.S. 546, 93 S. Ct. 1713 (1973), which involved the valuation of shares of an open-end mutual fund. The price obtainable by the executor or donor in whatever markets are available to him is the only fair measure of value.

Accordingly, amendment of Sections 2031 and 2512 (gift tax) is recommended to provide that tangible personal property be valued for estate and gift tax purposes at the price obtainable by the executor or donor in the market or markets available to him. If this proposal is coupled with the previously made one permitting an election of a delayed valuation date for hard to value assets, many of the valuation disputes that now occur would be avoided and the large expense incurred by estates possessing closely-held businesses in obtaining appraisals of them for tax purposes could also be reduced, if not entirely eliminated in a large number of cases.

H. Estate tax credit for gift tax paid

Section 2012 should be amended so that in computing the limitation on the estate tax credit allowed for gift taxes paid in respect of property included in the decedent's gross estate, the estate tax attributable to such property should equal the reduction in estate tax if such property were removed from the gross estate. At present, the estate tax credit for gift tax paid in respect to property included in a decedent's gross estate for estate tax purposes is limited to the lesser of the gift tax paid or the estate tax allocable to the gift.

Those limitations are computed under present law by a complicated method involving the average gift tax rate and the average estate tax rate. Substitution of the highest applicable bracket rates determined under present law would greatly simplify the computation of the credit and would reduce the number of cases in which the credit is partially lost by application of the limitations. Thus, the computation used to determine the amount of gift and estate taxes allocable to property subject to both taxes for purposes of the limitations should be changed to reflect the incremental amounts of gift tax and estate tax attributable to the doubly taxed property.

I. The spousal-transfers-to-others-problem (Sec. 2513)

Under present law, when a gift is made by a married person to a person other than his spouse, one-half of the gift can be treated as if made by the non-donor spouse for federal gift tax purposes. This is referred to as gift splitting by husband and wife. Gift splitting has been allowed since 1948 and came into the picture as a part of the tax legislation that was designed to equalize to some extent the tax situation in community and non-community property states.

If the subject matter of a gift is community property and the donee is not the spouse of the donor, the gift is one-half from each spouse without any election since each owns one-half of the donated property. Gift splitting in common law states produces the same gift tax result.

1. *Gift splitting at death.*—Gift splitting is not now allowed with respect to transfers made at death. That is, a surviving spouse cannot have one-half of the death-time transfers made by the deceased spouse to others attributed to her. The deceased spouse could make a marital deduction death-time transfer to the surviving spouse and she could in turn give it to a beneficiary of the deceased spouse and in effect produce an ultimate result comparable to the gift splitting result available for lifetime transfers. If a deceased spouse makes a death-time transfer of community property to another and the surviving spouse acquiesces, the result is a lifetime gift by the surviving spouse of one-half the community property and a death-time transfer by the deceased spouse of the other one-half. In a sense, it could be said that gift splitting is available for death-time transfers of community property while as to non-community property a more cumbersome procedure to accomplish the same end must be employed. To reduce the complications in relation to other than community property, and to achieve greater equality of treatment between community and non-community property, it is proposed that gift splitting be extended to death-time transfers.

2. *Splitting in ratios other than 50–50.*—The present law requires that one-half of the gift made by the donor spouse be attributed to the consenting non-donor spouse. The one-half rule is tied to the fact that a transfer of community property by the spouses is inherently half and half. It is proposed, if the 100 percent unlimited marital deduction is adopted, that the gift splitting be allowed on any basis agreeable to the consenting non-donor-spouse. If the 100 percent marital deduction is adopted, the donor-spouse could give any portion of an intended gift to his spouse and she could become the donor of that portion. The same result should be allowed to be accomplished directly by her consenting to be treated as the donor of any particular portion. The opening up of gift splitting in this way would also apply to community property, so that on a gift of community property to another, either spouse could consent to be treated as the donor of any portion of the total community property.

The extension of gift splitting to death-time transfers makes it easier to utilize the non-donor-spouse's bottom rate schedule. This is not particularly significant because under the unified transfer tax such utilization moves up the beginning rate bracket that will be applicable to future transfers, lifetime and death-time, by the consenting non-donor-spouse.

J. Repeal of the orphan's deduction

The 1976 Tax Reform Act added a new Section 2057 to the Internal Revenue Code, providing for a deduction equal to $5,000 per year for the number of years an orphaned child is under the age of 21. This deduction is granted for an interest in property which is includible in the decedent's gross estate and which "passes or has passed" from the decendent to the child either outright or in a form that, were the property passing to spouse, it would qualify for the marital deduction. The interest must be includible in the child's gross estate, is unavailable if the child has a surviving parent, even if there has been a divorce, and is unavailable where the child has been orphaned but his parent is survived by a spouse, although the latter is merely his step-parent. A relationship created by legal adoption is treated as one replacing a blood relationship, so the existence of a displaced natural parent of an adopted child will not bar the availability of the deduction, unless the adoption was intended solely to obtain the benefit of the provision. (How could that ever be proven?)

Interests qualifying for the orphan's deduction include outright bequests, bequests under the Uniform Gifts to Minors Act and trusts similar to those qualifying for the marital deduction, including a single trust for the benefit of a number of orphaned children as a group, called a "qualified minors' trust".

While only a very small minority of estates will qualify for the orphan's deduction, since no one ever knows in advance which estate will qualify, estate planning for any family with children under 21 or which may have children under 21, has to include an orphan's deduction provision (or at least the matter must be discussed with the clients). Failure to do this in the unlikely event of the client's estate being eligible for the orphan's deduction, will result in the loss of this deduction, producing additional tax, dissatisfaction with the attorney who prepared the estate plan and a potential malpractice claim against him.

The ambiguities and uncertainties inherent in the concept of obtaining the deduction, at least in any form of trust which will provide proper protection for the orphan's shares, the fact that the concept of treating orphans differently from other beneficiaries is inappropriate in an estate tax as distinct from an inheritance tax, and most important of all, the rareness of its utility but the universality of the need to include it in an estate plan, cries out for its elimination as unnecessary gimmickry.

K. Allowing the unified credit for gift tax purposes to be elective

The use of the unified credit for gift tax purposes should be made elective, so that where gifts of closely-held stock or other hard to value assets are made, the donor can elect to forego the exemption equivalent to the credit, pay a small gift tax (as he could before the 1976 Tax Reform Act) and obtain the benefit of a statute of limitations with respect to the values of the assets donated. The American Bar Association's Tax Section is currently working on a legislative recommendation on this subject.

L. Broadening the ascertainable standard exception to general powers of appointment

Section 2041(b)(1)(A) should be amended to extend the ascertainable standard exception. This permits a decedent to invade property for his benefit without having the property he has not used included in his estate, provided his invasion power is limited by an ascertainable standard relating to his health, education, support or maintenance. This exception from considering a power as a general power of appointment should be extended so it applies to a power exercisable by a decedent in favor of his dependents. Thus, the life beneficiary of a trust would then be able not only to invade corpus for his benefit under the ascertainable standard rule, but also to direct that it be paid to his dependents if needed for their health, education, support or maintenance.

M. The alternate valuation date should be extended to a year following death and returns not required until 15 ~~months after death~~

From the introduction of the concept of an alternate valuation date into the federal estate tax law at the start of the great depression of the 1930s until the Excise, Estate and Gift Tax Adjustment Act of 1970, the alternate valuation date was one year following death. In 1970, as a result of an expensive settlement of a postal strike, Congress accelerated the payment of estate and gift taxes by, among other things, providing that the federal estate tax return would be due within nine months (instead of fifteen months) of death, with an alternate valuation date of six months from death instead of one year.

The federal estate tax return filing requirements will apply only to less than three percent of all estate of decedents dying after 1980. In many estates to which they apply (estates in excess of $175,000), it is difficult to obtain all of the data necessary to file a complete and accurate return within nine months after death. As a result, in many if not most cases, extensions are requested for filing of estate tax returns, resulting in estates not being closed any faster by virtue of being required to file returns within nine months of death, since executors are usually able to convince the Internal Revenue Service that there is reasonable cause to allow extensions to fifteen months after death.

Since the objective of obtaining earlier distribution of decedent's estates (by shortening the time during which a federal estate tax return can be filed) has not really been accomplished for the small minority of estates large enough to file a federal estate tax return, there is little point in perpetuating the present practice. It would be far more sensible to go back to the fifteen month filing date requirement. As a corollary to this, a return to the former year from date of death alternate valuation date would be more equitable, since it would give estates a more reasonable period of time between the date of death and the alternate valuation date to experience market fluctuations.

N. Permit elections even after the date for filing the federal estate tax return has passed

Several elections, principally the one to use the alternate valuation date can only be made on a timely filed return (that is on a return filed within the prescribed period for filing the federal estate tax return or an extension thereof). The existing penalties for the late filing of a federal estate tax return (5% a month up to 25% of the tax shown due on the return, together with one-half of one percent (interrelated) interest, as well as the regular interest on late payments) are a sufficient deterrent to the late filing of a federal estate tax return. In cases where the estate can show reasonable cause for late filing and late payment of the tax, the late payment penalties (but not the interest) are excused.

It seems unnecessarily harsh to penalize an estate even further by preventing it from using the alternate valuation date election and other elections which can now only be made if the return is timely filed. While it may not have been the intent of the Congress to impose this as an additional penalty, and perhaps it was put in the law merely for the convenience of the Internal Revenue Service, since there are many elections (such as whether certain expenses are taken as deductions on the federal estate tax return or the estate's income tax return) which are adjusted after the filing of the federal estate tax return during an audit, there seems to be little reason to impose the terribly onerous penalty of loss of the use of the alternate valuation date and other elections in addition to the existing penalties for late filing. Accordingly, it is recommended that the alternate valuation date and other elections be available at any time while the estate tax statute of limitations remains open.

CONCLUSION

The proposals made in this statement have all been designed to retain the basic concept of the unified estate and gift tax system to prevent, retard and break up large concentrations of wealth, while at the same time ease the burdens, many of them caused by the tremendous inflation which has occurred just since 1976, on surviving spouses, family farms and businesses, and people who have acquired a modest amount of worldly goods which they wish to pass on to their descendants, other relatives and charities. Simplification of the administration of the tax laws and reduction of the costs of complying with them are also major considerations.

APPENDIX

BIOGRAPHICAL NOTE

Frank S. Berall is a partner in the Hartford, Connecticut law firm of Copp, Brenneman, Tighe, Koletsky & Berall. He received a Bachelor of Science in Applied Economics from Yale University in 1950, a Bachelor or Laws (now a Doctor of Laws) from Yale Law School in 1955 and a Master of Laws (in Taxation) from New York University School of Law in 1959.

Attorney Berall has been an adjunct faculty member at the Yale and University of Connecticut Law Schools and in the University of Hartford's Graduate Tax program. He is presently a Regent of the American College of Probate Counsel and Co-Chairman of its Estate and Gift Tax Committee, a member of the American Law Institute, a Senior Editor of the Connecticut Bar Journal, on the Editorial Board of Estate Planning Magazine, Chairman of the Committee on Estate Planning and Drafting; Life Insurance, of the American Bar Association's Real Property, Probate & Trust Law Section, a member of the Advisory Council of the University of Hartford's Tax Institute, the Executive Council of the International Academy of Estate and Trust Law and Co-Chairman of the Notre Dame Estate Planning Institute.

He was formerly Chairman of the Connecticut Bar Association's Tax Section and the Membership Committee of the American Bar Association's Tax Section, a member of the Connecticut State Tax Commissioner's Commission, Counsel to the Tax Committee of the Connecticut Governor's Strike Force for Full Employment, and served as a consultant to the Connecticut Governor's Commission on Tax Reform.

He is the author of a number of articles published by various tax and legal journals and frequently lectures in the field of taxation, probate and estate planning. He is listed in Who's Who in America (40th ed. 1978–1979) and Who's Who in American Law (1st ed. 1977 and 2nd ed. 1979).

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STATEMENT OF DAVE L. CORNFELD

My name is Dave L. Cornfeld. I am a partner in the law firm of Husch, Eppenberger, Donohue, Elson & Cornfeld of St. Louis, Missouri. I have practiced law in St. Louis for over 35 years, with heavy emphasis on tax and tax related matters, including probate and estate planning. I have taught a graduate course in "Pre-mortem and Post-mortem Estate Planning" as an adjunct professor at the University of Miami, and am currently a part-time member of the faculty of Washington University in St. Louis teaching the course on "Income Taxation of Estates and Trusts" in the graduate program there. At present, I am a Vice-Chairman of the Section of Taxation of the Americna Bar Association, serving as Editor-in-Chief of The Tax Lawyer.

I am here testifying in my individual capacity and not as a representative of any organization. The views expressed in this statement and in my testimony before this Committee are solely my own individual views and should not be construed as representing the views of the American Bar Association or the Section of Taxation of the American Bar Association or any other organization of which I am a member.

The present gift and estate tax laws (together with certain related income tax provisions) are a complicated maze of highly technical provisions which are extremely difficult for even the most experienced estate planner to comprehend. The law contains many inequitable and harsh provisions which as Senator Byrd has noted can have a potential devastating effect on the family and family-owned businesses. In many instances, it rewards artificial courses of conduct while penalizing natural familial financial activities and relationships. Where properly advised, husband and wife are compelled to conduct their finances in a manner which is not conducive to a sound happy family relationship. Inproperly advised, they may be subjected to excessive and inequitable taxation. In many instances, the law is ignored and unenforced with respect to family gifts because the ordinary citizen is unaware of the requirements and would probably be up in arms if made aware. Even where the taxpayer has competent counsel and is aware of the problems created by the gift and estate tax law, there is nevertheless an unnecessary deterrent effect upon the creation of capital and the growth of family-owned businesses.

In all too many instances, the complexity of the law compels unnecessarily high and unproductive legal and other administrative expense. In all such instances, the law should be changed. Revenue loss, if any, to the government would be minimal and more than offset by the benefits to the economic condition of our citizenry.

This testimony necessarily can cover only some of the more significant substantive and administrative problems. I shall attempt to cover these problems in principle rather than to recommend specific technical statutory language. Any specific detailed suggestions should be considered merely as illustrative of the prinicple discussed and not necessarily the only method of achieving the desired result.

GIFT TAX PROBLEMS

Transfers for consumption

Perhaps the area of gift taxation which is most ignored both in voluntary taxpayer compliance and in enforcement is the imposition of tax on gifts which are intended to be and are consumed by the donee. Typical situations involve support payments for the support and maintenance of parents or indigent relatives, for whom the taxpayer has no legal support obligation under state law, college tuition payments for adult children and other payments for the support and maintenance of adult children. I am satisfied that the number of gift tax returns filed reporting such gifts is far rarer than the number of such "gifts".

At present, the imposition of gift tax depends upon local law obligations of support which are far from uniform. In some states there may be a legal obligation to support an indigent parent, in most states there is not. Why should an individual who lives in a state which does not imppose a legal obligation to support a parent or other relative be penalized for recognizing a moral obligation? The income tax laws reward him with a special deduction. The gift tax law, if complied with, would impose a tax. The gift tax law should be consistent. Such "gifts" should be encouraged as contributing to a sounder society through healthier family relationships.

It is no solution to the problem created by the law, that in actual practice few such gifts are reported. It does not lead to a general respect for the law to have a tax which is generally ignored. It is also no answer that there may be partial relief through the existence of the annual exclusion. Even if increased from its present inadequate $3000 level, the exclusion is likely to be insufficient in most instances. Private college tuition alone today would exceed the highest increased level of exclusion seriously proposed. In addition, requiring the exclusion to be used for support creates inequitable treatment in comparison to taxpayers who can use the exclusion to create capital for their donees.

The American Law Institute, in its Federal Estate and Gift Tax Project in 1968 recommended the following:

Resolved, that an expenditure for: (1) any person residing in the Transferor's household, or the benefit of a minor child of the transferor, whether or not he resides in the transferor's household, or (2) current educational, medical or dental costs of any person, or (3) current costs of food, clothing and maintenance of living accommodations of any person or persons in fact dependent on the transferor, in whole or in part, for support, provided such expenditures are reasonable in amount, be excluded from transfer taxation under either a dual tax system or a unified transfer tax. A transfer is not an expenditure so as to come within this exclusion if it results in the transferee acquiring property, other than property usable by the transferee primarily for his educational or medical purposes, which will retain any significant value after the passage of one year from the date of the transfer.

I would recommend the adoption of the American Law Institute proposal with the following modification; there should also be an exclusion of gifts of the use of tangible property for personal use by the donee and not for the production of income, and of outright gifts of tangible personal property not exceeding $3,000 in value (or some other reasonable amount) for such personal use if such tangible personal property may be expected to lose at least one-fourth (or some other reasonable fraction) of its value within the first year after the gift. Under this recommendation, permitting a person to occupy premises owned by the taxpayer would not constitute a taxable gift whether or not dependency could be proved. Likewise, a "gift" of a television set could be disregarded even if an additional gift equal to the annual exclusion were also made.

At the present time many donors make gifts of exactly $3,000 a year in cash to family members without filing gift tax returns, blissfully unaware that they are required to file a return because during the same year they also made birthday gifts of ties or candy in addition, so that total taxable gifts for the year exceeded $3,000. While it may seem that the foregoing problem is of no real significance, the present rules under § 2035 would cause the entire $3,000 as well as the value of the tie or candy to be subject to estate tax if the donor dies within three years. It is not likely that under such a rule, audit controversies will arise with respect to estate taxes where such $3000 gifts have been made within 3 years of death.

Annual exclusion and split gift return requirements

Regardless of the rules for transfers for consumption, the present annual exclusion is too low. Despite inflation, the exclusion has remained at $3,000 since 1942. An increase at this time to at least $6,000 is long overdue.

The requirement that a retuen be filed in order to take advantage of the split gift provisions of § 2513 should be eliminated where the only gifts made by both spouses do not exceed the aggregate exclusions available on a split gift basis for such gifts. In many cases, married taxpayers who make gifts in excess of $3,000, but not more than $6,000, do not file returns in the mistaken belief that no return is required because "half of the gift belongs to the spouse". Such failure to comply with the literal legal requirements can cause serious adverse tax consequences in later years. Consent should be conclusively presumed where no adverse tax consequence to the spouse could result. Such elimination of a return requirement would affect the operation of present § 2035, but § 2035 could be easily modified to retain present results, if Congress so determines. As will be later seen, my own recommendation would be to eliminate § 2035 as well.

A further amendment to the provisions of § 2513 permitting split gifts should be made to allow such gifts to be split on any basis the spouses desire rather than only on a fifty-fifty basis. Such an amendment would permit spouses to equalize their available unified credits and gift tax brackets, in situations where one spouse has made a larger amount of taxable gifts than the other in prior years. Permitting spouses to equalize their respective tax liabilities would be conducive to sound familial relationships. Any revenue deferral resulting from such a change would be extremely minimal. It would be a worthwhile change for improved family relations and equity in the tax law.

Interspousal transfers

The present law imposes artificial limitations and restrictions on normal interspousal economic relationships, that is, the relationships which would be created absent any tax considerations. A system which would permit unlimited interspousal transfers without immediate tax would permit families to establish their interspousal economic relationships with only minimal regard for tax considerations. There should be no material overall revenue loss, but merely a deferral of tax payment at most until the death of the surviving spouse. Such deferral, however, would be of great significance to many families in planning for retirement and for security in the event of the death of the bread-winning spouse. Any revenue loss can be offset by Congress in its determination of the overall rate schedule. The husband-wife "marital partnership" should be permitted to utilize the full fruits of their joint labors unreduced by death taxes during their respective lifetimes.

The inequity of the present limitation on interspousal transfers has been aggravated by the unification of gift and estate taxes by the 1976 Tax Reform Act. As the American Law Institute stated in its April 30, 1968 draft discussion of Major Problems in Federal Estate and Gift Taxation, prepared by Professor A. James Casner as Reporter: "The 100 percent marital deduction is almost essential where a unified transfer tax is involved." The correctness of this observation has been proven as a result of the 1976 Tax Reform Act which unified the gift and estate tax.

Under the new law, there is a severe tax penalty on substantial interspousal gifts. Aggregate lifetime marital gifts in excess of $100,000 plus annual exclusions will result in a greater increase in the donee-spouse's gross estate than the resulting reduction in the donor-spouse's taxable base. As a consequence, there will be a greater combined tax on both deaths in every case where the donor-spouse predeceases the donee-spouse and the donee-spouse's estate will be subject to tax.

The following example will illustrate the effect of current law. For purposes of simplicity of illustration, the effects of the $3,000 exclusion and state death tax credit are ignored and the 1981 unified credit is used. It is assumed that the family has total assets of $1,000,000, all of which are "owned" by the spouse who will predecease the other. It is also assumed that the predeceasing spouse's Will take full advantage of the marital deduction and provides that all assets in excess of the maximum marital deduction are to be left in trust for the benefit of the surviving spouse, but in such a manner as to avoid estate tax thereon in the surviving spouse's estate at the surviving spouse's death. The tax calculations, showing the consequences or no gift and gift of $200,000, would be as follows:

	No gift	$200,000 gift
Donor's estate before gift	1,000,000	1,000,000
Gift to spouse	0	200,000

	No gift	$200,000 gift
Donor's estate at death	1,000,000	800,000
Maximum marital deduction at death	500,000	400,000
Taxable estate	500,000	400,000
Adjusted taxable gifts	0	100,000
Tax base	500,000	500,000
1981 tax	108,800	108,800
Donee's estate (gift and marital bequest)	500,000	600,000
1981 tax	108,800	145,800
Combined taxes of donor and donee	217,600	254,600

In the example, the additional $100,000 of gifts to the spouse costs the family $37,000 in additional tax. A sound tax system with due regard for improvement of family relationships should not discourage interspousal gifts.

Without an unlimited marital deduction an even greater inequity and tax trap for the unwary may result under the unified gift and estate tax law, if the interspousal transfer is made in the form of joint property. This may be illustrated by the following example (again for convenience, the annual exclusion is ignored): Assume a taxpayer has assets of $500,000 which he places in joint tenancy with his spouse as a gift. The gift will be treated as having a value of $250,000 resulting in a marital deduction of $125,000 and a taxable gift of $125,000. If the donee-spouse predeceases the donor-spouse, the entire amount will again belong to the donor. At the death of the donor, the donor will have a taxable estate of $500,000 and adjusted taxable gifts of $125,000 so that there will be an estate tax computed on $625,000 even though the entire family wealth never exceeded $500,000.

In addition to the problems caused by the limitations on the amount of marital deduction available for the gift tax or estate tax the present requirements for qualification of a gift or bequest for the marital deduction are too highly technical and interfere with the manner of making interspousal gifts which would be followed in the absence of tax consideration. The chief problem is caused by the so-called terminable interest rule. This rule denies any marital deduction if the interest transfered may pass to someone other than the spouse or the spouse's estate upon the occurrence or failure to occur of an event or contingency. There is an exception only for transfers of life estates with powers of appointment meeting highly technical requirements. This rule has led to much litigation, has increased the cost of will drafting and estate administration and interfered with the accomplishment of the donee or testator spouse's normal desires for disposition of the family assets to achieve financial security for the entire family.

Whether or not the unlimited marital deduction is adopted, the terminable interest rule should be eliminated. A deduction should be allowed for the value of any interest passing to the spouse. Such interests should be valued under normal valuation procedures but without regard to any contingency other than the spouse's death. In order to prevent tax avoidance, the following rule could be adopted:

Upon the occurrence or failure to occur of the event or contingency (including the death of the spouse) terminating the spouse's interest, the original gift or bequest to the donee-spouse would be revalued upon the basis of the actual facts. At such time, the donor-spouse, if living, would be treated as having made a non-marital gift to the extent that the value of the gift as revalued proved to be less than the marital deduction previously allowed. If the donor-spouse has died, then the estate tax previously assessed and paid would be similarly recomputed based upon the actual facts. The additional tax would be due within some reasonable period (such as 6 months) after the termination. Any tax due would be collectible out of the gift or bequest property, if collection could not be made from the donor or donor's estate.

The application of these rules to a specific example will illustrate. Let us assume that a decedent's entire estate is left in trust with income payable to the spouse for life or until the spouse remarries. A marital deduction would be allowed for the actuarial value of the spouse's life interest without regard to the remarriage contingency. However, if the spouse remarries five years after the decedent's death, the original marital deduction would be recomputed and allowed only to the extent of a five year income interest.

Administrative provisions—statute of limitations

The unification of the gift and estate taxes has created a serious problem for taxpayers with respect to valuation of gifts especially gifts of real estate and family held business interest. The amount of all taxable gifts (whether or not a gift tax is actually paid) are now added back to the taxable estate in determining the estate tax. The law is not entirely clear as to whether the valuation of such gifts as previously reported will be subject to review for estate tax purposes when the estate law return is audited even if a gift tax has been paid with respect to such gifts. My own interpretation of this law, absent regulations, is that a valuation which would be binding for gift tax purposes with respect to subsequent gifts would also be binding for estate tax purposes. See § 2001(b). However, unless a gift has been reported on a gift tax return with respect to which a gift tax has been actually paid or assessed, there is no statute of limitations with respect to the value of such previous gifts for the purpose of determining the tax bracket of subsequent gifts. See § 2504(c).

The unified credit is apparently mandatory and the Internal Revenue Service has already taken the official position that it can not be waived. The law is not entirely clear, however, whether if a taxpayer files a return reporting a gift and actually pays a tax (even though not required to), the provisions of § 2504(c) will be applicable. In any event, the taxpayer's executor may be required to litigate valuations of hard to value gifts such as farmlands or closely held business interests many, many years after the gift. As in almost all tax litigation, the burden of proof will be on the taxpayer. The passage of time plus the unavailability of the donor will make the task a difficult one for the executor of the donor's estate.

Thus, a procedure should be provided for the taxpayer to obtain certainty as to valuation of gifts even though the unified credit would otherwise eliminate any immediate tax. The law should be amended to permit a taxpayer to waive a portion of the unified credit for any taxable period for the purpose of invoking the provisions of § 2504(c). The waiver once made should be irrevocable for such taxable period so that the Internal Revenue Service would not be required to litigate only to find no immediate revenue at the end of the litigation even though it is successful. The waived portion of the unified credit should be available, however, for future gifts.

The proposed procedure is of especial importance for farmers and owners of closely held businesses since gifts of interest in farms, other real estate and closely held businesses present valuation problems leading to potential audit disputes. Interfamily gifts of such assets should be encouraged and not discouraged. The proposed procedure would eliminate a present chilling factor in the making of such gifts.

Joint property

Despite many adverse tax ramifications, acquisition and holding of property as joint owners with right of survivorship has remained extremely popular in this country. This form of ownership has many advantages from a non-tax viewpoint. While perhaps it is used chiefly to avoid the problems of probate, there are other sound non-tax reasons for use of such ownership form. In many states, for example, holding title as tenants by the entirety (one form of joint ownership) will provide protection against claims by the creditors of only one spouse.

In most cases the individuals utilizing this form of ownership are blissfully unaware of the tax consequences. In only a small fraction of the cases, are gift tax returns filed. In my own experience, I have many times had to advise clients to file delinquent returns reporting gifts made over a large number of prior years involving joint property. Happily, in most cases the amount of tax due has been small or non-existent. Prior to 1977, the combination of exclusion, marital deduction, and $30,000 specific exemption minimized the tax where the gifts were made over a number of years.

Prior to the 1976 Tax Reform Act, gifts of interests in joint tenancies always involved a double tax. Where one joint tenant furnished the entire consideration, there was an immediate gift for gift tax purposes, except in the case of real estate held jointly by spouses, in which case an election was required for gift treatment. However, upon the death of the donor joint tenant, the entire property was includible in his gross estate for estate tax purposes. The 1976 Tax Reform Act eliminated this inequity in the gift and estate tax treatment of joint property insofar as joint interests of spouses are concerned but the old inequitable treatment has been continued for other joint tenants such as parent and child. In many cases after the death of one parent, the surviving parent will transfer property into joint tenancy with children.

In many of these cases, there is an understanding that the entire income from the property will continue to be received by the parent and that the parent will control the sale and reinvestment. The transfer is made to avoid probate and sometimes in the mistaken belief that the child will be free to manage the property in case of the incapacity of the parent. If the parent has retained such rights, there should be no gift for gift tax purposes. However, unless a lawyer has been consulted (who would in any case discourage such arrangement and suggest more effective alternatives) these agreements are rarely documented and potential tax controversies at death are created. There is no justification for treating joint tenancies differently based upon the nature of the relationship of the joint tenants. To the extent that different treatment for gifts between spouses is justified, such treatment should be covered by the marital deduction provisions. Many, although not all, of the joint tenancy problems of spouses would be cured by an unlimited marital deduction provision.

In addition, there would appear to be no jurisdiction for treating joint tenancies in real property differently from joint tenancies in personal property. Gift tax treatment of all property, whether real or personal, held as joint tenants with right of survivorship, regardless of the relationship of the parties, should be made elective in the same manner as provided for tenancies by the entirety in real property under § 2515. Such a provision should have no material adverse effect on the revenue since the well advised taxpayer will not incur such a tax while the unknowledgeable or ill-advised taxpayer usually does not report such "gifts" prior to the time that the joint tenancy shows up on an estate tax return. While some interest and penalties on delinquent-gift taxes uncovered by estate tax audit procedures may add to the revenue, they can not be significant.

ESTATE TAX

Unlimited marital deduction and split bequests

For the reasons already stated with respect to lifetime interspousal transfers, an unlimited marital deduction should be allowed for estate tax purposes. While in most instances the well advised testator would probably not desire to take advantage of an unlimited marital deduction to its fullest extent, nevertheless the tax laws should permit the fullest interchange of property between spouses, both during lifetime and at death, so as to impose a minimum of interference with the marital relationship.

Just as the marital partnership is permitted to file income tax returns on a split income basis, so should the marital partnership be permitted to be taxed as a unit with splitting of assets for gift and estate tax purposes. In furtherance of this policy, the surviving spouse should be permitted an election in connection with the estate tax return of the decedent-spouse to have an amount up to one-half of all transfers to third parties made under the Will or by intestate succession to be treated as gifts made by the surviving spouse. Such a provision would permit the earliest effective utilization of the unified credit available to both spouses so as to minimize the death taxes payable by the marital partnership and conserving the family assets for the benefit of the spouses who earned and built up the estate, at least during their respective lifetimes. Such a provision obviously would merely permit a deferral until the death of the surviving spouse and should not materially reduce the aggregate taxes payable to the government. A similar provision was recommended by the American Law Institute in 1968.

Gifts within three years of death

The 1976 Tax Reform Act simplified the administration of the estate tax laws by amending Section 2035 relating to transfers in contemplation of death so as to eliminate any subjective test and substitute a mandatory inclusion for all transfers made within three years of death. However, because of the change to a unified gift and estate tax law, the provisions of Section 2035 are largely unnecessary to prevent avoidance of tax. The law and its administration could be greatly simplified if the provisions of Section 2035 were limited to those of Section 2035(c) relating to gift tax paid with respect to gifts made within three years of death, and (if the present rules relating to taxation of life insurance for estate tax purposes are retained), to transfers of life insurance.

With respect to other gifts, the section now serves only to pick up for taxation any appreciation in value of the property transferred over a period of less than three years but may also result in excluding from taxation any depreciation in value of such gifts between the date of the gift and date of death. The actual operation of the section is haphazard. It can operate unevenly and inequitably especially in cases of gifts of interests in farms, other real estate and closely held businesses if death unexpectedly occurs within the prescribed three year period.

The section as amended in 1978 also treats taxpayers inequitably in that a gift having a value of exactly $3,000 may be made the day prior to death and be excluded for estate tax purposes; whereas, a gift of $3,001 made two years, 364 days before death will be brought back into the estate.

Orphan's deduction

One of the best intentioned provisions of the Tax Reform Act of 1976 was the enactment of Section 2057 to provide an estate tax deduction for the benefit of orphans where both parents have died. Unfortunately, the section was made overly and unnecessarily technical. Consequently, additional expense has been imposed on all parents of minor children throughout the United States as a result of increased costs of preparing Wills to comply with the requirements of this section. While situtations in which the deduction will be available are fortunately extremely rare, every attorney preparing a Will for the parents of minor children must include a specially drafted complicated trust, and the legal expense is increased.

As Professor Kahn of the University of Michigan has pointed out, because of the current limitations and restrictions, it often will be necessary for good planning to have a testator create at leet two trusts for his orphaned children—one to qualify under § 2057 and a second to utilize more flexible provisions. The use of two trusts will increase trustee fees. If possible the tax law should be designed so as not to stimulate the use of otherwise inefficient means of passing a testator's estate to his children.

The chief complicating factor is the requirement conditioning the orphan's deduction on compliance with the provisions for interests of a surviving spouse under the marital deduction provisions. An attempt under the 1978 Revenue Act to simplify the provisions leaves much to be desired, and, for technical reasons, will be unusable in many cases. Even without regard to the relatively insignificant number of cases where this deduction will come into play, there should be no revenue loss if the existing restrictions would be eliminated so that the deduction would be allowable in every case where there are orphans and where the value of the interest passing for the benefit of the orphans, as a group, determined in accordance with ordinary valuation procedures, equals the amount of the permissible deduction. It should be noted, that the maximum allowable deduction for any orphan will be $105,000, and that even if that orphan were to die immediately thereafter with full vesting of that amount, there would still be no estate tax since the unified credit available would shelter more than that amount.

The orphans deduction provision is not the kind of provision which is susceptible to manipulation for tax avoidance purposes. Parents can be relied on to see that their Wills are written in such a way as to assure the availability to each child of the maximum available amount. The overly technical provisions are completely unnecessary.

Liquidity problems of estates

The greatest threat posed to the growth of small business in the United States and a major concern of all families relying for the livelihood on farms and family businesses is the requirement for cash to pay federal estate taxes. These taxes must be paid in cash within a short period of time after the death of the principal owners of the business. Recognizing that along with the non-tax problems which will be caused by the principal owner's death, there will be a substantial drain on the liquid assets of his estate, is it any wonder that the owners of small businesses are easily convinced of the desirability of sell outs to larger corporations. Even where an individual has substantial liquid assets, prudence would dictate that the individual not place his family in the position where all, or almost, of the liquid assets available at his death are used to pay the tax bill while the family is left with all of its eggs in one basket, a closely held business where the founder and driving force has just died.

The 1976 Tax Reform Act granted some additional relief in the enactment of a new Section 6166 permitting payment of a portion of the federal estate in installments over a 14 year period. Unfortunately the threshold eligibility requirements were made so strict that the relief is not available in many instances where it is needed. The requirement that the closely held business interest constitutes more than 65 percent of the decedent's adjusted gross estate is too severe. It must be recognized that the estate is still required to pay as much as 35 percent of the aggregate estate tax (the proportionate amount attributable to the non closely held assets) within 9 months of death, even where the section applies.

The stringency of the 65 percent requirement encourages unwise transfers of liquid assets in order to qualify and discourages transfers of closely held business interests to other members of the family. For example, a parent holding closely held stock constituting more than 35 percent of the parent's assets may desire to give some of the stock to induce a child to join the family enterprise. However, if the gift would reduce the parent's holding below the 65 percent threshold, the economic consequence upon death of the parent would be severe. On the other hand, where the holding is less than 65 percent, there is great temptation to strip oneself of other assets in order to meet the requirement.

While the provisions of section 6166A remain available for estates where the closely held business interest represents only 35 percent of the gross estate or 50 percent of the taxable estate, the other provisions of Section 6166A are less liberal than those of Section 6166. For example, the interest rate required of the estate under Section 6166A will be 12 percent per annum. The available return from most closely held family businesses, after payment of income tax, will not reach that rate. Under these circumstances the interst rate should not exceed 6 percent per annum.

Further, the provisions of Section 6166 and Section 6166A are confusing and create problems in administering because of differing rules and requirements. The sections should at least be made consistent. I would recommend that Sections 6166 and 6166A be combined with a threshold requirement of 35 percent of the adjusted gross estate (rather than the gross estate) or 50 percent of the taxable estate and otherwise with the more liberal provisions of each, if Congress desires to encourage the growth of family businesses.

In addition, the Tax Reform Act of 1976 changed the requirements of Section 303 of the Internal Revenue Code permitting a closely held corporation to redeem its stock for the purpose of providing cash for payment of estate taxes. The threshold eligibility requirements for Section 303 should be liberalized in order to grant liquidity relief for the holders of closely held stocks. Under present law, an estate could qualify for relief under Section 6166A, but be unable to use Section 303 to obtain the cash to meet the installment payments. At the very least, it should be restored to the pre-1976 requirements which were substantially the same as those under section 6166A.

One other problem under § 6166 and § 6166A is that a redemption of all of the stock will accelerate the due date for payment of the tax even though such redemption is made by the corporation on an installment note basis to provide payments as the corporation is able to meet them and as needed to pay the tax. Both sections should be modified to permit such installment redemption by treating corporate notes, or other corporate obligations, as stock of the redeeming corporation so as to prevent acceleration of the tax. The American Bar Association has approved a recommendation for the foregoing changes in Section 6166 and Section 6166A. A copy of the Report of the Committee of the Tax Section on Estate and Gift Tax proposing that recommendation is attached as Exhibit A.

Disclaimers

It is obviously desirable that the federal tax laws apply uniformly to all citizens regardless of residence and regardless of individual quirks of state law. In the Tax Reform Act of 1976 Congress enacted a new Section 2518 and section 2045 dealing with the subject of disclaimers.

Unfortunately, the new law is not entirely clear as to whether the disclaimer must also comply with state law as well as the new federal requirements. As a result, we are left with the same lack of uniformity which existed prior to the Tax Reform Act of 1976, except that persons desiring to disclaim must meet the more rigid tests of the federal law in those situations where state law is more liberal. No provision is made for those cases where state law does not permit a disclaimer.

The American Bar Association, prior to the Tax Reform Act of 1976, adopted a legislative recommendation permitting disclaimers under special federal rules even though ineffective under local law and providing for uniform disclaimer rules in a number of other situations not covered by the present law. A copy of this recommendation is attached as Exhibit B.

Generation skipping transfers

The new generation skipping tax imposed by the Tax Reform Act of 1976 has added a new dimension of complexity for the economic planning of the American family. Because of the newness of the law and the fact that to date there are no final regulations issued with respect to any of the provisions of this law, it is too early to attempt an analysis of all of the problems which this new chapter will create. I will mention only a few serious problems which should be corrected as promptly as possible in order to simplify family estate planning.

In connection with the effective date of the new law, the law was made retroactively applicable to trusts which were not irrevocable on June 11, 1976. An exception was made for transfers, in the case of a decedent dying before January 1, 1982, pursuant to a Will (or revocable trust) which was in existence on June 11, 1976 and was not amended at any time after that date in any respect which will result in the creation of or increasing the amount of any generation skipping transfer. Under proposed regulations, proposed by the Internal Revenue Service on December 22, 1978, the Service takes the position that any amendment which adds to a trust (other than an incidental addition resulting from an administrative or clarifying or other technical amendment) will completely disqualify the Will or revocable trust as an exempt Will or revocable trust.

While the provisions of the Tax Reform Act of 1976, as amended by the Revenue Act of 1978, are certainly susceptible to such an interpretation, it is obviously inequitable and a trap for the unwary. Thus, the execution of a codicil cancelling a $500.00 specific bequest may subject the entire residuary trust under a Will to the new generation skipping provisions, even though the decedent dies before January 1, 1982. On the other hand, it is clear under the Code that if an addition of $500.00 is made to an otherwise exempt trust in existence on June 11, 1976, only a proportionate amount of the trust will be subject to the new tax.

The effective date provisions should be modified so as to treat any increase in the amount of a generation skipping transfer under a Will or revocable trust in existence on June 11, 1976 as causing only a proportionate taint and not a complete taint. The existence of this trap requires substantial extra legal time by knowledgeable lawyers in reviewing documents and advising clients with respect to proposed amendments to Wills which were in existence on or before June 11, 1976. Such additional costs should not be imposed upon the American family. In the light of the complexity of Chapter 13, it would be entirely reasonable and no substantial threat to the revenue if the effective date were amended so as to apply only to transfers pursuant to a Will (or revocable trust) of decedents dying after December 31, 1981, without regard to the date of execution of such Will or revocable trust.

Another provision of Chapter 13 which interferes with normal family estate planning is the provision which treats a trustee as a beneficiary even though such trustee cannot receive any personal benefit fromt the trust. As a result, testators who do not desire to use a professional fiduciary but would prefer to use one of the children or other younger generation member of the family as trustee cannot do so without subjecting the trust to the new tax, except in very limited circumstances under Section 2613(e)(1). Even under those limited circumstances the testator will require an extremely knowledgeable and sophisticated draftsman to prepare the Will. The use of family members as fiduciaries should be encouraged and not discouraged. Not only is there a saving of substantial expense, but family members will have the greatest personal knowledge of the family needs. It is only natural for a testator to choose an able son or daughter as the trustee to determine whether encroachments for the surviving parent or other family member are needed, especially in cases where the surviving parent or other family member is incapacitated. The law should be amended to provide that the term "power" shall not include any power which is exercisable only in a fiduciary capacity and which cannot be exercised for the benefit of the holder thereof.

Another provision which should be modified in order to permit more flexibility in family arrangements is the provision for a $250,000 exclusion for transfers to grandchildren. The Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, stated:

"This $250,000 exclusion is to be available in any case where the property vests in the grandchild (i.e., the property interests will be taxable in the grandchild's estate) as of the time of the termination or distribution, even where the property continues to be held in trust for the grandchild's benefit, and regardless of whether the grandchild receives his interest under the express terms of the trust, or as the result of the exercise (or lapse) of a power of appointment with respect to the trust."

The "vesting" requirement imposes conditions which may not be for the best interests of the family. I can cite one example from my own recent experience. I was consulted by an elderly couple whose total assets were approximately $150,000. All except one of their children are well off economically and do not need any assistance, but one son is not in secure economic circumstances. They have a number of grandchildren, one of whom has health problems and is retarded. The father of that grandchild has a reasonably adequate earned income. They expressed the desire that after their death all of their property should be held in trust to provide income for the son in need for his lifetime and thereafter the income to be available for the retarded grandchild for her lifetime. If the father of the retarded grandchild should predecease his brother so that the grandchild might need income, then the grandchild should become a beneficiary of the trust at that time, with income to be divided between the grandchild and her uncle. Upon the deaths of both the son and the retarded grandchild they desired their property to be divided among all of the other grandchildren. Under the foregoing facts, unless the retarded grandchild were given a general power of appointment by Will the trust of $150,000 would be subjected to a substantial generation skipping tax—as much as $38,800. On the other hand, there was no assurance that the grandchild would not exercise that power of appointment at some future time, thus sending the remaining assets to strangers rather than their other grandchildren as desired by this couple. There would appear to be no reason why the $250,000 exclusion should not be applicable to the actuarial value of the interests of the grandchildren at the time of a taxable termination. If the grandchildren die before receiving the $250,000 there will be a generation skipping transfer at that time, so that no revenue would be lost. The law should be so amended.

EXHIBIT A

COMMITTEE ON ESTATE AND GIFT TAXES

TAX SECTION RECOMMENDATION No. 1979-6

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO MAKE CONSISTENT THE TESTS FOR ACCELERATION OF UNPAID INSTALLMENTS OF ESTATE TAX IN CASES OF WITHDRAWALS FROM CLOSELY HELD BUSINESSES AND DISPOSITIONS OF INTERESTS IN SUCH BUSINESSES, AND TO LIMIT THE ACCELERATION OF UNPAID INSTALLMENTS WHERE OBLIGATIONS OF THE BUSINESS ARE RECEIVED IN SUCH TRANSACTIONS.[6] *Adopted with the following changes:*

Substitute the word "in" for "and" in the third line of the first Resolution, and insert after the first Resolution:

FURTHER RESOLVED that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results.

COMMITTEE ON ESTATE AND GIFT TAXES

TAX SECTION RECOMMENDATION No. 1979-6

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO MAKE CONSISTENT THE TESTS FOR ACCELERATION OF UNPAID INSTALLMENTS OF ESTATE TAX IN CASES OF WITHDRAWALS FROM CLOSELY HELD BUSINESSES AND DISPOSITIONS OF INTERESTS IN SUCH BUSINESSES, AND TO LIMIT THE ACCELERATION OF UNPAID INSTALLMENTS WHERE OBLIGATIONS OF THE BUSINESS ARE RECEIVED IN SUCH TRANSACTIONS.

RESOLVED that the following Resolutions be submitted by the Section of Taxation to the House of Delegates of the American Bar Association:

RESOLUTIONS

RESOLVED, that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to make the provisions governing termination of the privilege of paying estate tax ~~and~~ in installments upon withdrawals of property from a closely held business consistent with the rules governing termination of such privilege upon the disposition of interests in such businesses, and to provide that acceleration of unpaid installments of estate tax will not occur where interests in a closely held business are exchanged for obligations of the business;

REPORT

Summary

Under present law a withdrawal from a closely held business or a disposition of an interest in such a business can, under certain circumstances, cause acceleration of the remaining installments of estate tax without providing the estate with sufficient liquid assets to pay the tax.

It is recommended (i) that the provisions for acceleration of unpaid installments upon withdrawal of funds or other property from a closely held business be made consistent with those relating to dispositions; and (ii) that the provisions for acceleration upon certain dispositions of an interest in the business be modified so that, if obligations of a closely held business are received in exchange for an interest in such business, such an exchange will not trigger acceleration of unpaid installments of estate tax, but such obligations will thereafter be treated as an interest in the closely held business, so that a subsequent distribution, sale, exchange, or disposition may trigger acceleration.

Discussion

Sections 6166 and 6166A permit an executor to elect to pay in installments the estate tax attributable to an interest in a closely held business. Under present law a termination of the privilege of making installment payment of estate tax under section 6166 or section 6166A occurs if stated percentages of the value of the closely held business with respect to which the installment payment privilege was determined are withdrawn, or if stated percentages of the decedent's interest in such closely held business are distributed, sold, exchanged or otherwise disposed of, other than by transfer to certain permitted beneficiaries or pursuant to certain tax-free exchanges. Under section 6166(g), a withdrawal of one-third or more of the value of the closely held business, or a disposition of one-third or more of the decedent's interest, causes such acceleration. Under section 6166A(h) a withdrawal of fifty percent or more of the value of the closely held business, or a disposition of fifty percent or more of the decedent's interest, causes such acceleration.

These acceleration provisions do not apply, however, to withdrawals from a corporation or dispositions of its stock which qualify for special treatment under section 303 if the estate tax paid on or before the date of the first installment which becomes due after the distribution (or, under section 6166, any earlier day which is one year after the date of the distribution), equals or exceeds the amount received from the corporation pursuant to the section 303 redemption. Except for section 303 redemptions, however, a withdrawal or disposition exceeding the relevant limitation terminates the privilege of paying the tax in installments regardless of whether the withdrawal or disposition provides the estate with sufficient funds to pay the remaining tax in a lump sum.

The withdrawal test in its present form applies only to a narrow class of taxpayers. Because the withdrawal test covers only withdrawals of one-third or fifty percent of the value of the business (depending upon whether section 6166 or section 6166A applies), the test will not apply unless the estate has at least that large an interest in the business. For example, if the estate had a one-fourth interest in a partnership which qualified as a closely held business the estate could withdraw its entire interest without causing acceleration of the remaining unpaid installments.

The disposition test, on the other hand, is more even-handed in its operation. It applies to any disposition of one-third or fifty percent of the estate's interest in the business, (depending on whether section 6166 or section 6166A applies), regardless of whether the interest disposed of represents one-third or fifty percent of the entire business (as the case may be).

It is proposed to eliminate the disparate treatment which now exists between the withdrawal and disposition tests by eliminating the withdrawal test as an independent test and by making withdrawals subject to the same limitations as are applicable to dispositions. The disposition test would be further amended to prevent acceleration to the extent that the consideration received in the disposition consists of obligations of the closely held business, since such obligations are not likely to be marketable except at a substantial discount. It is proposed that such a transaction not be considered a disposition that would trigger acceleration. However, the obligations would then in effect take the place of the original interest in the business, so that a subsequent disposition of the specified percentage of the obligations would trigger acceleration. Consideration was given to the difference that will exist between pre-death and post-death obligations received in exchange for a closely held business interest and such difference was not regarded as material in light of the policy considerations inherent in sections 6166 and 6166A.

The Section of Taxation has no earlier recommendation that is related to this Recommendation. Recommendation No. 1976-8, which deals in large part with the same subject matter as this Recommendation, adopted by the Section at the 1976 Annual Meeting, 29 TAX LAWYER 1165, was not submitted to the House of Delegates as a result of the passage of the Tax Reform Act of 1976.

No member of the originating committee or of the Council of the Section of Taxation is known to have a material interest in this Recommendation by virtue of a specific employment or engagement to obtain the result of the Recommendation. It is recommended that the amendment be given only prospective application. In that case, clients would not be affected in any pending matter.

PROPOSED STATUTORY LANGUAGE

RESOLVED that the Section of Taxation implement the foregoing by urging the following amendments, or their equivalent in purpose and effect, on the proper committees of the Congress:

SEC. 1. Section 6166(g)(1) is amended to read as follows (eliminate matter struck through, insert new matter in italics):

(1) DISPOSITION OF INTEREST~~.—WITHDRAWAL OF FUNDS FROM BUSINESS.~~

~~(A) If—~~

~~(i) one third or more in value of an interest a closely held business which qualifies under subsection (a)(1) is distributed, sold, exchanged, or otherwise disposed of, or~~

~~(ii) aggregate withdrawals of money and other property from the trade or business, an interest in which qualifies under subsection (a)(1), made with respect to such interest, equal or exceed one third of the value of such trade or business,~~

~~then the extension of time for payment of tax provided in subsection (a) shall cease to apply, and any unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.~~

(A) If—

(i) one-third or more in value of an interest in a closely held business which qualifies under subsection (a)(1) is withdrawn from the business, or distributed, sold, exchanged, or otherwise disposed of,

then the extension of time for payment of tax provided in subsection (a) shall cease to apply and any unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary; provided, however, that to the extent that obligations of the closely held business are received in exchange for all or any part of such interest in the closely held business, such exchange shall not be deemed a withdrawal from the business, or distribution, sale, exchange, or other disposition of such interest in the business for purposes of this subparagraph, and such obligations shall thereafter be treated as an interest in the closely held business for purposes of applying this subparagraph to any subsequent payment, distribution, sale, exchange, or other disposition, in whole or in part, of such obligations.

(B) In the case of a distribution in redemption of stock to which section 303 (or so much of section 304 as relates to section 303) applies—

(i) subparagraph ~~(A) (i) does~~ *shall* not apply with respect to the stock redeemed; and for purposes of such subparagraph the interest in the closely held business shall be considered to be such interest reduced by the value of the stock redeemed~~, and~~.

~~(ii) subparagraph (A)(ii) does not apply with respect to withdrawals of money and other property distributed, and for purposes of such subparagraph the value of the trade or business shall be considered to be such value reduced by the amount of money and other property distributed.~~

This subparagraph shall apply only if, on or before the date prescribed by subsection (a)(3) for the payment of the first installment which becomes due after the date of the distribution (or, if earlier, on or before the day which is 1 year after the date of the distribution), there is paid an amount of the tax imposed by section 2001 not less than the amount of money and other property distributed.

(C) Subparagraph (A)~~(i) does~~ *shall* not apply to an exchange of stock pursuant to a plan of reorganization described in subparagraph (D), (E), or (F) of section 368(a)(1) nor to an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, but any stock received in such an exchange shall be treated for purposes of subparagraph (A)~~(i)~~ as an interest qualifying under subsection (a)(1).

(D) Subparagraph (A)~~(i) does~~ *shall* not apply to a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive such property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent.

Sec. 2. Section 6166A(h)(1) is amended to read as follows (eliminate matter struck through, insert new matter in italics):

~~(1) WITHDRAWAL OF FUNDS FROM BUSINESS; DISPOSITION OF INTEREST.~~

~~(A) if~~

~~(i) aggregate withdrawals of money and other property from the trade or business, an interest in which qualifies under subsection (a), made with respect to such interest, equal or exceed 50 percent of the value of such trade or business, or~~

~~(ii) 50 percent or more in value of an interest in a closely held business which qualifies under subsection (a) is distributed, sold, exchanged, or otherwise disposed of,~~

~~then the extension of time for payment of tax provided in this section shall cease to apply, and any unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.~~

(1) DISPOSITION OF INTEREST.

(A) If 50 percent or more in value of an interest in a closely held business which qualifies under subsection (a) is withdrawn from the business, or distributed, sold, exchanged, or otherwise disposed of, then the extension of time for payment of tax provided in this section shall cease to apply, and any unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary or his delegate; provided, however, that to the extent that obligations of the closely held business are received in exchange for all or any

part of such interest in the business, such exchange shall not be deemed a withdrawal from the business, or a distribution, sale, exchange, or disposition of such interest in the closely held business for purposes of this subparagraph, but such obligations shall thereafter be treated as an interest in the closely held business for purposes of applying this subparagraph to any subsequent payment, distribution, sale, exchange, or other disposition, in whole or in part, of such obligations.

(B) In the case of a distribution in redemption of stock to which section 303 (or so much of section 304 as relates to section 303) applies,

~~(i) subparagraph (A)(i) does not apply with respect to withdrawals of money and other property distributed, and for purposes of such subparagraph the value of the trade or business shall be considered to be such value reduced by the amount of money and other property distributed, and~~

(ii) subparagraph (A)~~(ii) does~~ *shall* not apply with respect to the stock redeemed; and for purposes of such subparagraph the interest in the closely held business chall be considered to be such interest reduced by the value of the stock redeemed.

This subparagraph shall apply only if, on or before the date prescribed by subsection (e) for payment of the first installment which becomes due after the date of the distribution, there is paid an amount of the tax imposed by section 2001 not less than the amount of money and other property distributed.

(C) Subparagraph (A)~~(ii) does~~ *shall* not apply to an exchange of stock pursuant to a plan of reorganization described in subparagraph (D), (E), or (F) of section 368(a)(1) nor to an exchange to which section 355 (or so much of section 356 as relates to section 355) applies: but any stock received in such an exchange shall be treated for purposes of such subparagraph as an interest qualifying under subsection (a).

(D) Subparagraph (A)~~(ii) does~~ *shall* not apply to a transfer of property of the decedent by the executor to a person entitled to receive such property under the decedent's will or under the applicable law of descent and distribution.

Sec. 3. The amendments made by sections 1 and 2 shall be effective with respect to estates of decedents dying after the date of enactment thereof.

EXPLANATION OF PROPOSED STATUTORY LANGUAGE

Conforming and clerical amendments have not been made.

EXHIBIT B

COMMITTEE ON ESTATE AND GIFT TAXES

TAX SECTION RECOMMENDATION No. 1974-2

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE FOR ESTATE AND GIFT TAX TREATMENT OF DISCLAIMERS

RESOLVED that the following Resolutions and accompanying Report be submitted by the Section of Taxation to the House of Delegates of the American Bar Association:

RESOLUTIONS

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to provide comprehensive uniform rules for the exemption from estate and gift taxes of property that is disclaimed in a specific manner within a specified time;

FURTHER RESOLVED that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results;

FURTHER RESOLVED that Recommendations Nos. 1968-12a and 13a, relating to exemptions of disclaimers from estate and gift taxation, proposed by the Section of Taxation in August 1968, 11 TAX LAWYER 93, 94 (1968), 93 A.B.A. REP. 212, 213 (1968) and embodied in section 72 of H.R. 11450, 89th Cong., 1st Sess. (1965), be withdrawn.

REPORT

Summary

Whether disclaimed property is exempted from estate and gift taxation now depends primarily on state law. The state laws are not uniform on this subject and many states have no law on it at all. It would be desirable to have comprehensive federal disclaimer rules which apply uniformly for federal tax purposes.

It is recommended that estate and gift tax rules be enacted to provide that the disclaimer by a person or his personal representative of property receivable by him by inheritance, gift or other transfer is not to be considered a taxable transfer by him for estate or gift tax purposes, provided that required formalities are followed. Requirements would include the taking of appropriate action within nine months after the death of a decedent, the effective date of a transfer, or in the case of a future interest, the date on which the taker's interest is finally ascertained and indefeasible.

Discussion

It is desirable to exempt disclaimed property from gift and estate taxation because persons should be free to refuse gifts or inheritances without suffering adverse tax consequences if they do not receive any benefits from the property.

Under present law, whether a disclaimer of property passing by devise, bequest, intestacy or gift is a transfer causing estate and gift tax consequences for the person making the disclaimer depends on state law. A number of states have enacted disclaimer legislation, many of them patterning their law after the Model Disclaimer Act. The Commissioners on Uniform State Laws have recently proposed a Uniform Disclaimer Act, based upon the Model Act.

Despite the existence of such laws and provisions concerning disclaimers, assignments and releases in several sections of the Internal Revenue Code of 1954 and Treasury Regulations thereunder, there is insufficient specificity with respect to the estate and gift tax consequences of a disclaimer. An even more serious problem exists in states that have not enacted statutes, since the common law background of disclaimers is spotty. Court decisions on the issues presented differ greatly, often focusing on the technicalities of local law with respect to the presence or absence of passage of title to the recipient prior to his disclaimer. These technicalities appear irrelevant to the tax policy questions involved. Uniformity of tax treatment is highly desirable and is the major goal of the Recommendation.

Cases have held, for example, that disclaimers of property passing by intestacy are transfers subject to estate and gift tax. *Hardenbergh v. Commissioner*, 198 F.2d 63 (8th Cir. 1952), *cert. denied*, 344 U.S. 836 (1952); *William L. Maxwell*, 17 T.C. 1589 (1952). Other cases have long held to the contrary as to property passing by will. *E.g., Brown v. Routzahn*, 63 F.2d 914 (6th Cir. 1933), *cert. denied*, 290 U.S. 641 (1933). The decisions depend in large part on whether the disclaimer was effective under local law. State law is not uniform (even where there are disclaimer statutes) and it is not always clear. The differences in result are undesirable because similar transactions in different states are not now being treated uniformly for estate and gift tax purposes.

The estate and gift tax laws do not contain a definition of the term "disclaimer" or a provision of general application establishing the tax consequences of a disclaimer. A disclaimer is, however, treated in certain specific instances otherwise than as a receipt of an interest in property followed by a transfer by the recipient. With respect to the donee of a general power of appointment, sections 2041(a)(2) and 2514(b) provide that the disclaimer or renunciation of a power during lifetime is not deemed a release and is, therefore, not a taxable event. With respect to the transferor of property which is the subject of an effective disclaimer by the recipient, sections 2055(a) and 2056(d), relating to the estate tax charitable and marital deductions, respectively, state that the affected property is deemed to pass from the transferor directly to the person who receives it by reason of the disclaimer. Reg. §25.2511-1(c) is also significant because it provides rules that must be followed, in addition to compliance with state law, in order for a disclaimer to be valid for gift tax purposes. However, the regulation does not purport to be comprehensive and does not solve the problem of variation in state laws.

Existing state and federal law concerning the time within which a disclaimer must be made is unclear. This is illustrated by *Keinath v. Commissioner*, 480 F.2d 57 (8th Cir. 1973), *rev'g* 58 T.C. 352 (1972). In that case the son of a testator was given a remainder interest under a trust if he survived his mother. He was a trustee and was aware of the interest. The mother's life estate continued for 19 years and shortly after she died the son disclaimed the remainder. The disclaimer was valid under state law; however, the Tax Court held, relying on Reg. §25.2511-1(c), that a disclaimer must not only be valid under state law but must be made within a reasonable time after the recipient learns of the bequest in order to be non-taxable. The Court of Appeals reversed holding that under state law a vested remainder subjected to divestiture may be disclaimed within a reasonable time after death of the life tenant. The result in that case appears to be correct, but it illustrates the difficulty caused by a lack of uniform federal law. There could be many variations of the facts in the *Keinath* case with different results in different states depending upon the application of local law.

The Recommendation would amend both the estate and gift tax laws by providing similar, comprehensive disclaimer provisions.

The Recommendation would provide that a refusal to accept property passing by intestacy, which would be effective as a disclaimer in the case of a bequest or devise, would be an effective disclaimer of an intestate share. This should result in uniformity of treatment, even though a state without a disclaimer statute would for purposes of local property law and state death taxes not recognize the disclaimer.

The Recommendation would eliminate the undesirable situation illustrated in the *Keinath* case by providing a uniform federal standard for determining the time within which a disclaimer must be made. In the case of a future interest it would be within nine months after the event when the taker of the interest is finally ascertained and his interest has become wholly indefeasible. The result under that test would be the same as the one reached in *Keinath*. To be effective the disclaimer must be in writing, must describe the disclaimed property and must be signed and acknowledged by the person disclaiming. Within the time prescribed the disclaimer must be delivered to the person benefiting from it or to the fiduciary or other person in possession of the property. A person may not disclaim after the right to do so has been waived or the property has been accepted.

A disclaimer made within the time and in the manner prescribed by the federal statute may nevertheless be ineffective under state law. In such cases the disclaimer may still be treated as effective under the federal statute if the property is transferred within the federal time limit to the persons who would have been entitled thereto had the disclaimant predeceased the prior holder. Such a transfer would not be regarded as an acceptance of the property or an exercise of proprietary control. It is recognized that in some situations taxpayers may not be able to make the necessary transfer under state law and therefore may not be able to take advantage of the statute.

Joint interests vesting as the result of survivorship may be disclaimed within nine months after the death of the deceased joint tenant to the extent that the interest is includible in the deceased joint tenant's estate. To the extent that the property is not includible in the estate of the deceased joint tenant, the disclaimer must be made no later than nine months after creation of the joint tenancy.

The Recommendation would permit a disclaimer by a personal representative. This will allow an effective disclaimer to be made where the designated taker is an infant, or is incompetent, or where death occurs within the time allowed for making a disclaimer. The right of a personal representative to disclaim is, of course, subject to his fiduciary obligations and the limitations of local law.

No provision is made for any adjustment in the transferor's taxes which may result from a disclaimer. The need for such adjustments could result from changes in the amounts claimed as marital or charitable deductions or if the transfer failed and the property reverted to the transferor. Unless the transferor has provided in the instrument of transfer (his will or trust instrument) for the redirection of the property in the event of a disclaimer, the recipient of the disclaimed interest will be determined under applicable local law.

The Reporter's Study of the American Law Institute Federal Estate and Gift Tax Project (p. 96) recommends that the person making a disclaimer be permitted to direct the destination of the property in his disclaimer. This recommendation was considered but rejected because it is inconsistent with an underlying premise of proposed sections 2045 and 2518 that control over property should give rise to a tax to the person having such control. The power to redirect constitutes control over the property similar to a general power, and should be treated similarly, whether or not the recipient derives a benefit from the property.

The subject matter of the Recommendation was brought to the attention of the Section as a result of recent state legislation affecting disclaimers, the action of the American Bankers Association in recommending similar legislation and a reexamination of prior disclaimer recommendations, discussed below, which are now thought to be inadequate.

The Recommendation would supersede Recommendations Nos. 1958-12a and 13a relating to exemptions of disclaimers from the estate and gift taxes proposed by the Section of Taxation in August 1958, 11 TAX LAWYER 93, 94 (1958), 83 A.B.A. REP. 212, 213 (1958), and embodied together in section 73 of H.R. 11450, 89th Cong., 1st Sess. (1965). Unlike the prior recommendations, this Recommendation (1) gives definitions of a disclaimer and property which may be disclaimed, (2) provides for disclaimers by a legal representative, (3) sets forth the technical requirements for a valid disclaimer for federal tax purposes and (4) provides for the time within which the disclaimer must be made. The prior recommendations were far more limited in scope, merely providing that a disclaimer was not to be considered a transfer and that a refusal to accept an intestate interest would be as effective as a disclaimer of a bequest or devise.

It is recommended that the proposed amendments apply to disclaimers made after the date of enactment. In such case, neither members of the Section of Taxation nor their clients would be affected in any pending matters.

The Recommendation was formulated by the Section's Committee on Estate and Gift Taxes. It is within the special competence of the legal profession because of the profession's interest in promoting rules of taxation which are equitable and uniformly applied.

No member of the Council and no member of the Committee on Estate and Gift Taxes who actively participated in preparing this Recommendation has any material interest in it by virtue of a specific employment or representation of clients.

PROPOSED STATUTORY LANGUAGE

RESOLVED that the Section of Taxation implement the foregoing by urging the following amendments, or their equivalent in purpose and effect, on the proper committees of the Congress:

Sec. 1. Part III of subchapter A of chapter 11 of subtitle B (Estate Tax) is amended by adding thereto the following new section (insert new matter in italics):

Sec. 2045. DISCLAIMED PROPERTY.

(a) GENERAL RULE.—The value of the gross estate shall not include the value of any property disclaimed by the decedent.

(b) DEFINITIONS.—For purposes of this section—

(1) The term "disclaimer" means an irrevocable, unqualified refusal to accept property, or any part thereof, made and delivered as required by subsection (c).

(2) The term "property" means any interest in property which, if not disclaimed, could be included in the gross estate of the decedent.

(c) REQUIREMENTS FOR DISCLAIMER.—

(1) IN GENERAL.—No disclaimer of property shall be effective unless—

(A) such disclaimer is in writing, describes the disclaimed property, is signed by the person making the disclaimer and acknowledged, and is delivered to the person or persons benefiting therefrom or to the fiduciary or other person in possession of the property; and

(B) such disclaimer is delivered—

(i) in the case of a present interest in property which, if not disclaimed, would have been acquired by gift within the meaning of chapter 12, not later than nine months after the date of the gift;

(ii) in the case of a present interest in property which, if not disclaimed, would have been acquired by bequest, devise or inheritance from another decedent, not later than nine months after the date of such decedent's death;

(iii) in the case of a present interest in property which, if not disclaimed, would have been acquired by the exercise, release or lapse of a power of appointment, not later than nine months after the date of the exercise, release or lapse; or

(iv) in the case of any future interest in property, not later than nine months after the event when the taker of the interest is finally ascertained and his interest has become indefeasible.

(2) SPECIAL RULES.—For purposes of paragraph (1)(B) of this subsection—

(A) clauses (i), (iii) and (iv) of paragraph (1)(B) shall apply to all property which, if not disclaimed, would have been acquired by gift within the meaning of chapter 12, including such property as may be required to be included in the gross estate of the donor under section 2035, 2036, 2037, 2038, 2041 or 2042.

(B) Notwithstanding subparagraph (A), if the beneficiary of life insurance proceeds under a policy that has been acquired by gift within the meaning of chapter 12 during the lifetime of the insured is a person

other than the donee of the policy, clause (iv) of paragraph (1)(B) shall apply to the disclaimer of such proceeds.

(C) Clause (ii) of paragraph (1)(B) shall apply to the interest of another decedent which passes to the decedent as surviving joint tenant or tenant by the entirety, but only to the extent that such interest is required to be included in the gross estate of the other decedent under section 2040.

(D) Clause (iv) of paragraph (1)(B) shall apply to the interest of a beneficiary in an annuity or other payment described in section 2039.

(3) EFFECT OF ACCEPTANCE OR WAIVER OF RIGHT TO DISCLAIM.—Any other provision of this section notwithstanding, no disclaimer shall be effective if the person making the disclaimer accepts the property, or exercises proprietary control or waives, in writing, the right to disclaim.

(4) DISCLAIMERS INEFFECTIVE UNDER LOCAL LAW.—A disclaimer of property which is ineffective under governing state law shall be given effect for the purpose of this section if the property is transferred, within the time herein prescribed for delivery of a disclaimer, to the person or persons who would have been entitled thereto had the disclaimant predeceased the prior holder of the property.

(5) DISCLAIMER BY PERSONAL REPRESENTATIVE.—A disclaimer made by a personal representative shall be given effect for the purpose of this section if made within the time and in the manner prescribed herein. A personal representative is an executor or administrator of the estate of a decedent or a guardian, committee or conservator of the property of an infant or incompetent, or a person performing substantially similar functions under applicable local law.

Sec. 2. Subchapter B of chapter 12 of subtitle B (Gift Tax) is amended by adding thereto the following new section (insert new matter in italics):

Sec. 2518. DISCLAIMED PROPERTY.

(a) GENERAL RULE.—A disclaimer of property shall not be considered to be a transfer of the property by the disclaimant.

(b) DEFINITIONS.—For purposes of this section—

(1) The term "disclaimer" means an irrevocable, unqualified refusal to accept property, or any part thereof, made and delivered as required by subsection (c).

(2) The term "property" means any interest in property, the transfer of which could be subject to the tax imposed by this chapter.

(c) REQUIREMENTS FOR DISCLAIMER.—

(1) IN GENERAL.—No disclaimer of property shall be effective unless—

(A) such disclaimer is in writing, describes the disclaimed property, is signed by the person making the disclaimer and acknowledged, and is delivered to the person or persons benefiting therefrom or to the fiduciary or other person in possession of the property; and

(B) such disclaimer is delivered—

(i) in the case of a present interest in property which, if not disclaimed, would have been acquired by gift within the meaning of this chapter, not later than nine months after the date of the gift;

(ii) in the case of a present interest in property which, if not disclaimed, would have been acquired by bequest, devise or inheritance, not later than nine months after the date of the decedent's death;

(iii) in the case of a present interest in property which, if not disclaimed, would have been acquired by the exercise, release or lapse of a power of appointment, not later than nine months after the date of the exercise, release or lapse; or

(iv) in the case of any future interest in property, not later than

nine months after the event when the taker of the interest is finally ascertained and his interest has become indefeasible.

(2) SPECIAL RULES.—For purposes of paragraph (1)(B) of this subsection—

(A) Clauses (i), (iii) and (iv) of paragraph (1)(B) shall apply to all property which, if not disclaimed, would have been acquired by gift, including such property as may be required to be included in the gross estate of the donor under section 2035, 2036, 2037, 2038, 2041 or 2042.

(B) Notwithstanding subparagraph (A), if the beneficiary of life insurance proceeds under a policy that has been acquired by gift within the meaning of this chapter during the lifetime of the insured is a person other than the donee of the policy, clause (iv) of paragraph (1)(B) shall apply to the disclaimer of such proceeds.

(C) Clause (ii) of paragraph (1)(B) shall apply to an interest in property which passes to a surviving joint tenant or tenant by the entirety, but only to the extent that such interest is required to be included in the gross estate of the deceased tenant under section 2040.

(D) Clause (iv) of paragraph (1)(B) shall apply to the interest of a beneficiary in an annuity or other payment described in section 2039.

(3) EFFECT OF ACCEPTANCE OR WAIVER OF RIGHT TO DISCLAIM.—Any other provision of this section notwithstanding, no disclaimer shall be effective if the person making the disclaimer accepts the property, or exercises proprietary control or waives, in writing, the right to disclaim.

(4) DISCLAIMERS INEFFECTIVE UNDER LOCAL LAW.—A disclaimer of property which is ineffective under governing state law shall be given effect for purposes of this section if the property is transferred, within the time herein prescribed for delivery of a disclaimer, to the person or persons who would have been entitled thereto had the disclaimant predeceased the prior holder of the property.

(5) DISCLAIMER BY PERSONAL REPRESENTATIVE.—A disclaimer made by a personal representative shall be given effect for purposes of this section if made within the time and in the manner prescribed herein. A personal representative is an executor or administrator of the estate of a decedent or a guardian, committee or conservator of the property of an infant or an incompetent, or a person performing substantially similar functions under applicable local law.

SEC. 3. Section 2041(a)(2) is amended to read as follows (insert new matter in italics):

(2) POWERS CREATED AFTER OCTOBER 21, 1942.—To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive. A disclaimer of such a power *made in accordance with section 2046* shall not be deemed a release of such power. For purposes of this paragraph (2), the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised.

SEC. 4. So much of subsection (a) of section 2055 as precedes paragraph (1) thereof is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(a) IN GENERAL.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers (including the interest which falls into any such bequest, legacy, devise, or transfer as a result of ~~an irrevocable~~ *the* disclaimer of a bequest, legacy, devise, transfer or power, if the disclaimer is made before the date prescribed for the filing of the estate tax return *and in accordance with section 2045*).

SEC. 5. Section 2056(d) is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(d) DISCLAIMERS.—

(1) BY SURVIVING SPOUSE.—If under this section an interest would in the absence of a disclaimer *of such interest* by the surviving spouse, be considered as passing from the decedent to such spouse, and if a disclaimer of such interest is made by such spouse *in accordance with section 2045*, then such interest shall, for the purpose of this section, be considered as passing to the person or persons entitled to receive such interest as a result of the disclaimer.

(2) BY ANY OTHER PERSON.—If under this section an interest would, in the absence of a disclaimer by any person other than the surviving spouse, be considered as passing from the decedent to such person, and if a disclaimer of such interest is made by such person and as a result of such disclaimer the surviving spouse is entitled to receive such interest, then—

(A) if the disclaimer of such interest is made by such person before the date prescribed for the filing of the estate tax return ~~and if such person does not accept such interest before making the disclaimer~~, *and in accordance with section 2045*, such interest shall, for purposes of this section, be considered as passing from the decedent to the surviving spouse, and

(B) if subparagraph (A) does not apply, such interest shall, for purposes of this section, be considered as passing, not to the surviving spouse, but to the person who made the disclaimer, in the same manner as if the disclaimer had not been made.

SEC. 6. Section 2514(b) is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(b) POWERS CREATED AFTER OCTOBER 21, 1942.—
The exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power. A disclaimer ~~or renunciation~~ of such a power of appointment *made in accordance with section 2518*, shall not be deemed a release of such power.

SEC. 7. The amendments made by sections 1 through 6 shall apply to disclaimers made after the date of enactment thereof but shall not affect adversely any existing rights.

EXPLANATION OF PROPOSED STATUTORY LANGUAGE

Under sections 1 and 2 of the Recommendation new sections 2045 and 2518 are added to the Code to provide comprehensive rules for the disclaimer of interests in property for estate and gift tax purposes. Sections 2041(a)(2), 2055(a), 2056 (d)(1), 2056(d)(2) and 2514(b) are amended by eliminating any material which defines or limits a disclaimer and by referring in all cases to new sections 2045 and 2518 for the definition of a disclaimer.

As an alternative drafting technique, sections 2045 (relating to disclaimer for estate tax purposes) might have incorporated by reference a substantial portion of the text of section 2518 (relating to disclaimer for gift tax purposes). However, because there are some differences between the estate and gift tax statutes and because it seems desirable to have a complete statement of the law within chapter 11 (estate tax) as well as within chapter 12 (gift tax), the alternative drafting technique was not adopted.

Section 3 of the Recommendation amends section 2041(a)(2) to refer to section 2045, specifying that any disclaimer of a power of appointment, if not to be deemed a release of such a power, must be made in accordance with section 2045.

Section 4 of the Recommendation amends the first paragraph preceding subparagraph (1) of section 2055(a) in a similar manner, by deleting the requirement in that section that a disclaimer be irrevocable (since such a requirement exists in section 2045) and adding the requirement that a disclaimer under section 2055 be made in accordance with section 2045.

Section 5 of the Recommendation makes similar amendments to section 2056 (d) by requiring that a disclaimer made by a surviving spouse under section 2056(d)(1) be made in accordance with section 2045 and providing in a similar manner for a disclaimer by any other person under section 2056(d)(2), as well as deleting the now superfluous requirement that the person disclaiming the interest has not accepted the interest before making a disclaimer.

Section 6 of the Recommendation amends section 2514(b) to provide that a disclaimer of a power of appointment for gift tax purposes shall be made in accordance with section 2518.

Section 7 of the Recommendation provides that the amendments apply to disclaimers made after the date of enactment. In order to avoid a possible constitutional issue it is also provided that no existing rights would be affected adversely, *e.g.*, where at the time of enactment the time had expired within which a disclaimer could be made under the federal law, a disclaimer would still be effective if made within any longer time limit under applicable state law.

Clerical and conforming amendments have been omitted.

Statement of Edward C. Halbach, Jr.

SUMMARY OF PRINCIPAL POINTS

A. Gift Tax Annual Exclusion: No increase in the annual exclusion is recommended because the tax relief would be distributed selectively, regressively and in ways that complicate taxpayer behavior rather than simplifying matters, as could be done if like revenue sacrifice were used to fund other specifically needed reforms; even the legitimate problems an increased annual exclusion might alleviate could better be addressed by redefining gifts to exclude certain transfers for education and consumption.

B. Liquidity and Special Use Valuation: The selective (and discriminatory) benefits inherent in these "subsidies" for small business and farms should be cautiously handled to minimize intrusion upon equitable treatment of taxpayers and upon incentives for the benefited taxpayers to provide for the liquidity needs of their own estates; these and also simplicity factors suggest that emphasis be shifted from special use valuation to the tax deferral rules and that the latter be carefully reviewed.

C. An Unlimited and Simplified Marital Deduction:

1. No current proposal for reform could do so much for simplicity and evenhandedness in the transfer taxes at so reasonable a cost as a 100% exemption for interspousal transfers.

2. Inequitable double taxation (plus some undesirable pressure to use trusts) could be avoided by such a change, as could inequities caused by the order of spouses' deaths as well as unfortunate harshness and distortions with respect to inter vivos transfers and co-ownership between spouses.

3. The principal costs would be some revenue loss, mostly temporary.

4. Short of a 100% deduction, several worthwhile but less complete reforms are possible.

5. The terminable interest rule should be eliminated or greatly simplified, with no significant revenue implication.

D. Other Important Areas for Reform

1. Joint tenancies should be treated as equal tenancies in common for both greater equity and greater simplicity, and revenue is not at stake.

2. Sections 2035–2038 and also § 2039(c) need quite thoroughgoing reexamination, hopefully in the context of an unlimited marital deduction as well as to adjust to the 1976 unification of the gift and estate taxes.

3. The 1976 orphans deduction should be relieved of its treacherous, intrusive and wholly unnecessary qualifying requirements—or else it should be repealed.

4. The 1976 disclaimer rule should be clarified and improved by repealing a subsection which precludes socially and equitably desirable post-mortem corrections in planning, for its present operation is undesirable, probably not intended by Congress and not based on realistic revenue concerns.

E. The Generation-Skipping Tax: No particular proposals for legislation are presented, but a watchful Congressional interest is urged for this new and inherently complicated area of future development that is of such great long-range significance and where there already are signs of dubious administrative rulemaking—even in the view of one who strongly endorses this major step in tightening up the transfer tax system.

The estate and gift tax provision of the Tax Reform Act of 1976 responded to several major structural and policy issues affecting the taxation of wealth transfers during life and at death. Most significant were the unification of the gift and estate taxes and the enactment of a tax on generation-skipping transfers. Subsequent actions have cleaned up or undone some of what were widely considered to have been the most grievous errors of that legislation. In my view, however, mistakes remain in some aspects of the 1976 changes, and further changes are needed elsewhere, especially in revising the law to fit the context of the new unified tax structure. Sufficient attention has not yet been given to the need for improved equity and simplification—and purported simplification will prove illusory if we do not honor the equitable objective of affording like treatment to taxpayers who, in all fundamental respects, are similarly situated. Petty or arbitrary distinctions invite inequity and require tedious, often manipulative planning, and thus produce complexity.

Simplicity, in its most significant sense, is not a matter of merely avoiding complex language in a statute but is properly a matter of not injecting complexity, distortions and the need (or opportunity) for tedious, manipulative and costly planning into the personal and financial lives of taxpayers. A provision that taxes or does not tax depending on details, distinctions or requirements that are irrelevant or insignificant from a policy viewpoint is a provision that requires expensive lawyer-work in order to avoid unnecessary taxation while also exposing those without counsel (or whose counsel are guilty of technical oversight) to harsh treatment unlike that given others whose positions in all properly relevant respects are identical. The transfer taxes remain replete with flaws simply awaiting corrections that are or ought to be noncontroversial; and, of course, other matters offer opportunities for important long-run simplification and improved equity but involve serious policy questions or, in my opinion at least, political difficulties.

In short, our long-run goal should be a sound, fair, efficient system that is both simple to understand and, more importantly, simple to live and operate within. The first goal of any revenue reductions that are acceptable to Congress in this area should therefore be to "finance" worthy permanent reforms that will improve the overall quality of the tax system—a capital investment in the system itself. Such an investment will pay dividends indefinitely in the form of reduced costs of administration by government and of compliance by taxpayers, in the form of enhanced respect and honesty on the part of taxpayers whose behavior is fundamental to our self-assessment system, and in the form of greater natural equity and hence reduced economic distortion and planning costs in arranging the personal, financial and testamentary affairs of taxpayers.

INCREASED GIFT TAX ANNUAL EXCLUSION—A DUBIOUS IDEA

A number of proposals have suggested increasing to $5,000 or $6,000 the present $3,000 per-donee annual exclusion in the gift tax. Despite the antiquity of the $3,000 figure, I believe such an increase is not only unnecessary but highly undesirable. If substantial relief is to be offered in the gift tax or elsewhere, it would be far more advantageous to grant that relief by underwriting reforms or concessions where significant problems exist. Also, an enlarged annual exclusion offers significant escape only for the extremely wealthy and even then only for those who are induced to make, wisely or unwisely, substantial inter vivos gifts. The increase would thus aid taxpayers on a selected basis that is both regressive and based on no worthwhile tax policy objective. In addition, it would tend toward further inequitable treatment of taxpayers who ought to be viewed as similarly situated and would invite complexity in planning, especially with respect to those for whom substantial gift programs would present problems of liquidity and control because their primary assets are closely held business or family farming interests—often the very people we are seeking to relieve of undue pressures, burdens and complexities. Tax relief, if it is to be given, will be better allocated, simpler and more helpful to these and other taxpayers if it takes the form of an increased marital deduction, an enlarged unified credit and gentler rates.

Even the traditional generosity of the gift tax annual exclusion has been justified on the ground of simplicity of administration and compliance—i.e., "not to have Internal Revenue agents under our Christmas trees." Well-to-do taxpayers, especially if married and blessed with large families (children, sons- and daughters-in-law and grandchildren) can now annually and with no transfer tax impact make extraordinary amounts of gifts to deplete their estates. To double the exclusion would in many instances allow such taxpayers to give away as much as $250,000, or even more, entirely tax free and without so much as denting their unified credits.

Inflation and problems with certain types of unreported gifts, however, may present problems worthy of some attention. As prior studies have suggested, the most significant of these problems can be dealt with by articulating (or providing for regulations to articulate and clarify) what is now a de facto exclusion for transfers for education or consumption, where the essential net effect is not to enlarge the transferee's own estate. An argument might even be made that the gift of an expensive automobile or furniture (e.g., as wedding gifts) should be exempted under such a definition, much as they are now often disregarded; but even here a husband and wife giving to a newly wed couple would have $12,000 of exclusion available to them under present law, especially if gift splitting were simplified and granted in typical situations without the necessary of a return, as the law ought to provide anyway.

LIQUIDITY AND SPECIAL VALUATION

I should like to raise some doubts, if I can, concerning the understandable temptation to confer privileges selectively upon certain taxpayers, which also means to discriminate against others, in order to deal with liquidity problems or to offer incentives and subsidies to certain activities. I am among the many in the public who believe that the special use valuation adopted in 1976 was a mistake, the general purposes of which might better be accomplished in other ways and the principle effects of which were to create inequities and complexities. If special incentives are deemed appropriate for the family farm and small business, it would be better if these openly took the form of subsidies to all who are interested in those opportunities rather than of special advantages conferred only upon those fortunate enough to inherit such opportunities. These objections would not apply to continuation by a surviving spouse, whose needs are better and more appropriately taken care of anyway through interspousal exemption or at least a liberalized marital deduction.

To the extent the concern involves liquidity, reasonable but cautiously subsidized borrowing from the government via tax deferral is preferable. Even here, when special privileges involved there are both the danger of inequity and the inevitability of complexity (not to mention sporadic relief within the intended class) due to the need for rules defining and confining eligibility. Some restraint and imagination with respect to such eligibility rules, however, can help significantly to reduce such complexity and sporadic relief.

It is difficult to see why one group of heirs should be preferred over another merely on the basis of the manner in which the decedents made their fortunes, and it is difficult to see why special privileges should be available only to those who are attempting to retain a business that has been given to them rather than to pay off the much higher debt burden necessary to acquire or develop that business or farming enterprise on their own. Temporary problems during a period immediately following an owner's death, however, may well justify special aid to meet liquidity needs at temporarily subsidized interest rates. Here, I suggest serious consideration be given to shifting emphasis from special valuation (§ 2032A) entirely to better integrated and rationalized deferral privileges (reworking §§ 6166, 6166A and their kindred). All in all, the types of questions here involved and the arguments in favor of such special privileges are not always easy to resist, but I believe it worthwhile to re-examine our approach, to shift our emphasis and to consider whether the transfer taxes themselves are a good place to express so many of our social and economic values. The price we are paying is high in terms of equity and complexity, and the results are not as good as they might be if death tax relief were sought in other ways.

EXEMPTION OF INTERSPOUSAL TRANSFERS

Despite reservations I once had about a 100 percent marital deduction, I have become convinced that the complete exemption of interspousal transfers—essentially along lines recommended by the 1969 Treasury Studies—is highly desirable and to be preferred to the present 50 percent/$250,000 rule. Total or expanded interspousal exemption is consistent with underlying policies of the transfer taxes, would contribute significantly to equity in their operation and would offer more simplification in tax administration and estate planning than any other type of reform. It would also improve the structural background against which to deal with other troublesome problems in the gift and estate tax laws (e.g., joint ownership, employee benefits and some of the most distressing of the business/farm problems). In addition to total or partial expansion of the marital deduction, a total or partial revision of the rules of qualification (the terminable interest rule and its power-of-appointment trust exception) is called for.

In its 1969 report, following an excellent, long-term, comprehensive study of the estate and gift taxes, the Treasury noted that existing rules "have curtailed the use of some natural forms of transfers between spouses." After mentioning some of such problems caused by the terminable interest rule, the report noted the unfortunate necessity of planning to insure "that no more property than the exact amount needed to utilize the marital deduction passes to the surviving spouse" because the result of "overqualifying" by will or through joint ownership "is to leave property in a way in which it is taxable in the surviving spouse's estate without a corresponding deduction in the first decedent's estate." The report continues: "It does not appear, then, that transfers of property between husband and wife are appropriate occasions for imposing tax. An especially difficult burden may be imposed . . . when property passes to a widow, particularly if there are minor children. The present system of taxing transfers between spouses does not accord with the common understanding of most husbands and wives that the property they have accumulated is 'ours.' Furthermore, . . . the distinctions drawn by existing law between transfers which qualify for the marital deduction and those which do not qualify have generated drafting complexities, artificial limitations upon dispositions, and considerable litigation." Tax Reform Studies and Proposals (U.S. Treas. Dept., Feb. 5, 1969) p. 358.

The limited 1976 increase in the marital deduction as it applies to moderate sized estates ($250,000 or the traditional 50% of the adjusted gross estate), fails to resolve effectively many of the troublesome problems concerning interspousal transfers. Any specific figure will require constant revision; $250,000 represented substantial property five years ago, today represents a nice home and in a few years will represent a garage.

1. *Revenue loss.*—The Treasury was right, I believe, not to be inhibited in its proposals, by concern over revenue loss, most of which would be temporary and a small price to pay for a long-range improvement in the transfer tax system. (At one point estimates of long-run revenue loss from a 100 percent deduction were put at 7 percent of transfer tax receipts, but a substantial portion of any such loss has already been imposed by the 1976 changes in the allowable deduction for the vast majority of previously taxable estates.)

The one enduring form of revenue loss from a 100 percent marital deduction would actually be loss of revenue that ought not to be collected anyway and which *is* not collected from planned estates: double tax in the spouses' generation under certain circumstances. Property left to the surviving spouse in excess of the presently allowable marital deduction is taxed both in the first decedent's estate and then again in the survivor's (with an inadequate p.p.t. credit or none at all). This burden falls typically on estates that can least afford it, and this double tax reaches beyond both the purposes and design of our present tax law. Thus, unfortunately, the 50 percent rule requires the use of trusts to provide for one's spouse if the second tax is to be avoided—an ironic inversion of the generation-skipping problem. This modest revenue loss is therefore virtually dictated by goals of fairness.

Now that the transfer taxes have been integrated, the other "loss" from a 100 percent marital deduction—a temporary revenue loss—should be modest and soon recouped. This is actually a deferral of revenue from a greater deferral of taxes than is now allowed by the limited deduction. In this respect, however, the planning advantages and disadvantages of the marital deduction must be understood and considered realistically by policymakers as well as by estate planners. After all, the primary advantage of the marital deduction is in allowing equalization of the spouses' estates (with deferral to that extent), and this is already allowed by existing law. Beyond this estate equalization level, planners must weigh alleged advantages of further tax deferral against the combined disadvantages (1) of increasing the aggregate tax base of the two spouses and (2) of subjecting the property eventually to a higher rate of taxation under the progressive rate structure on the second death. Note that unification of the taxes has removed understandable earlier concern over the possible effects of gifts the survivor might make during the deferral period. Note also that, as a practical matter, deferring a transfer tax is not like the interest-free loan that results from deferring income tax: the government, in effect, gets its tax-share of the property by a proportional sharing in the property's fruits until the tax is finally collected; the larger tax base at the later time (income and appreciation during the deferral period) compensates fully for the deferral, and may even overcompensate due to rate progression. Thus, it will rarely be desirable under a graduated, unified transfer tax for the property owners to plan for more than the estate splitting already allowed by present law.

2. *Harshness, inequity and other objections to the present system.*—In addition to the inequity of double taxation in both estates of property passing to the survivor in excess of the present marital deduction ceiling (mentioned above), several other concerns should be noted in justification of a liberalized marital deduction ceiling.

One additional inequity is described in the 1969 Treasury report: "The proposal for the unlimited marital deduction, as it applies to the gift tax, will be of advantage where the poorer spouse dies first. Under present law, the minimum tax is paid if the estate is split equally between husband and wife for tax purposes by, for example, taking a 50 percent marital deduction on the estate of the first to die, paying tax on half, and then paying tax on the other half at the death of the survivor. . . . This tax saving is lost (except in a community property state) if the poorer spouse dies first. It could be preserved by giving half the property to the poorer spouse during life but under present law the gift tax marital deduction (which is limited to half of the actual gift to the spouse) would involve a tax penalty at the time of the gift. The proposal would permit a married couple to so arrange their property holdings that there would be no tax penalty arising from the order of their death. This would also remove an undesirable discrimination between common law and community property states." 1969 Studies, p. 359.

Furthermore, among the most troublesome practical problems and inequities of the gift tax is that which arises when the independent property of one spouse is treated as "ours" and is converted to jointly owned (especially joint tenancy or community) property. The problem results from the gift-tax marital deduction being limited to 50 percent of the property given inter vivos, whereas the present so-called 50 percent deduction at death is really an exemption of 100 percent of the amount transferred up to a maximum of 50 percent of the adjusted gross estate. The lifetime-transfer deduction, therefore, does fairly correspond to the advantages of community property systems. The 100 percent marital deduction would, of course, resolve this problem too; the 1976 modification (which allows complete exemption for the first $100,000, no exemption for the next $100,000 and 50 percent for the excess over $200,000) neither resolves the problem in most substantial estates, nor does it do anything to eliminate the unrealistic requirement of record keeping, even with respect to modest gifts. If complete interspousal exemption is not adopted, other steps should be taken to remove the often harsh problems of unintended gifts and the unrecognized, sporadically enforced tax liabilities that result from the natural, almost instinctive and tax-neutral behavior of placing "our" property in concurrent ownership.

3. *Alternatives to the 100 percent deduction.*—Absent a complete exemption of interspousal transfers, this array of current problems can be dealt with in a practically limited but reasonably workable way by allowing a 100 percent marital deduction only for inter vivos gifts (not changing the ceiling for transfers at death), reinforced by a rule that restores to the gross estate (and thus charges against the marital deduction at death) transfers made during the last three years of the donor's lifetime (cf. IRC § 2035). Another approach could be to extend the present nonrecognition-of-gift rule for joint-tenancy and tenancy-by-the-entirety land (IRC § 2515) to other forms of co-ownership by husband and wife, and to personalty as well as realty, with appropriate adaptations.

4. *The terminable interest rule.*—The 1969 Treasury Studies and many other proposals have recognized that the present terminable interest rule is unnecessary; it is retained only out of sheer inertia. Because it is sadistically complex, treacherous even for the skilled who are mortal, and unduly harsh with some regularity, it should be changed now. There is no reason to further the demand for sophisticated counsel and to create excessive risks for non-specialists and their clients, whether in the context of a 50 percent or 100 percent marital deduction rule. (At present, just to note one set of examples, general power of appointment properties are often included in a survivor's gross estate under § 2041 even though the power is defective to qualify a trust for the marital deduction in the first spouse's estate under § 2056—result: wholly unwarranted double taxation again!)

Where a survivor receives only a life interest or certain other limited interests in property, a deduction could be allowed in the first estate if the survivor consents to later taxation in his estate (or as a gift if the interest ends during life), with the increased tax to be born at marginal rather than average rates entirely from such marital deduction property. A similar provision was suggested in the 1969 Treasury Studies. Short of this, the law should at least be changed to eliminate all of the technical marital-deduction requirements that exceed the requirements for inclusion in the survivor's estate, so that the terms of the terminable interest rule and the risks to the taxpayers are confined more rationally to the polciy purposes underlying the rule.

5. *Conclusion: A Workable Marital Deduction.* A combination of (a) a simple new rule to replace the present terminable interest rule and (b) either (i) an unlimited marital-deduction or (ii) rules that would eliminate both inadvertent gifts and the need for tax-avoidance trusts for spousal provisions in excess of the deduction would result in a tax law far less intrusive into private decisions and planning than the present law, and such a combination would also alleviate the almost brutal inequities of the present marital-deduction rules. Absent tax policy considerations to the contrary, an ideal state of affairs would allow a property owner to provide for his spouse as he sees fit, without tax consequences wither influencing or turning on his specific decision. This type of neutrality, together with resolving the most urgent of the small business/family farm liquidity problems, is achievable with equity and simplicity throughout the interspousal transfer area without significant, long-term revenue loss.

JOINT TENANCIES

Section 2040 and other aspects of the estate and gift tax treatment of joint tenancies and tenancies by the entirety are a nightmare to taxpayer (both in administration and planning) and government alike; yet it is a nightmare that has an easy, appropriate and revenue-neutral solution. In fact, the present approach has no justification now that the estate and gift taxes have been unified.

Evidence enough of the law's difficulty is the increasing length and detail of § 2040. Additional provisions were added in 1976 and readjusted in 1978 to deal with problems which need not exist but which were created by an approach that is no longer warranted because the problems for which it was designed no longer exist. Essentially, IRC § 2040 provides a consideration-furnished test for determining inclusion in the gross estate at death, with a 1976 amendment for qualified interspousal tenancies plus some further 1978 corrections and amendments; overall the scheme is as deficient as it is complex, because even elaborate refinements cannot fit a large square into a small hole. Furthermore, § 2515 (an unfortunately designed, limited rule of non-recognition) can be exempted (see above), or ought to be expanded and adapted if the present gift tax marital deduction is not improved.

In short, all that is needed under our present unified transfer tax system is to treat joint tenancies as if they were tenancies in common, treating each co-owner as holding an equal interest. For both estate and gift tax purposes this would correspond to both property law and tax policy realities because of the unilateral right of severance possessed by each joint tenant. With respect to tenancies by the entirety (where they exist), however, this treatment does not correspond precisely to the realities of property law in that the interests of the spouses are not typically equal or subject to severance by unilateral action. Nevertheless, informed commentary and also the earlier proposals of both the American Law Institute and the Treasury (1969) support this type of proposal, disregarding the distinguishing characteristics of tenancies by the entirety; this seems especially appropriate inasmuch as that title form (unlike joint tenancy) is available only to husband and wife. The resulting comparability of treatment for all forms of concurrent ownership, including community property, effects a startling simplicity and equity of treatment.

The case for change in this area is thus a simple one based on fairness, simplicity and reality: (a) joint tenancy and other forms of concurrent ownership are matters about which the public, especially spouses, are generally misinformed, unaware and virtually incapable of compliance as a practical matter; (b) inequity and complexity go hand in hand in this area, as in unusual; (c) past efforts at correction have understandably failed in a scheme that fails to reflect the realities either of family life or of property law; (d) administration and enforcement by the government is at best difficult; (e) equity with community property residents can be achieved by the change; and (f) revenue is not in issue. In all honesty, if there are serious, valid arguments from any quarter to be made against such a change I have not heard them and they have not been stated in any of the hearings during which nothing more than understandable preoccupation with more urgent concerns has led to the neglect of this area of obvious and significant reform.

EMPLOYEE DEATH BENEFITS

Recent Congressional efforts have sought both to rationalize and to limit the special treatment of qualified employee benefit plans and other favored retirement and death benefit programs. The topic is no doubt politically delicate, but I believe that the special exempt treatment of death benefits is unjustified in the estate tax; the considerations are in reality far different from what they are in the income tax, where the policies and the issues are essentially only those of when and how to tax, rather than issues of exemption.

I see no justification for these particular forms of wealth transmission to be singled out from other ways of providing for one's family. The complexities and the discrepancies in treatment should, I believe, and readily can be removed. If a 100% maritial deduction were adopted, the advantages of eliminating special privileges in the death benefit area could be obtained with a minimum of distress and controversy.

LIFETIME TRANSFERS INCLUDED IN THE GROSS ESTATE

Only the press of more urgent Congressional business and the haste with which the estate and gift portions of the 1976 Tax Reform Act were enacted would seem to explain the failure then to rewrite International Revenue Code §§ 2035–2038, the entire function of which either ceased or changed with the integration of the estate and gift taxes. After all, the essential purpose and effect of unification was to eliminate the enormous opportunities for tax avoidance through inter vivos gifts and to reduce the significance of whether a transfer was subject to the gift or estate tax. Now that this has been done, there should be a thorough reexamination of the rules dealing with will substitutes and the whole question of when an inter vivos transfer should be deemed sufficiently complete to be removed from the estate.

Essentially, as both the American Law Institute and the United States Treasury recommended earlier when these matters were patiently and carefully examined, under a unified system rules should and can be designed to prevent the application of both taxes to a given transfer. There is no reason for earlier rules to be retained or merely patched up, and to perpetuate complexities and risks of inequity, when the problems for which the earlier rules were designed have for the most part (although not entirely) become extinct. Even § 2035 is virtually a relic, except for dealing with specialized problems involving life insurance and so-called "gross up" for tax payments on certain lifetime gifts. Some of the questions about the precise manner and details of revision (as distinct from whether or not it needs to be done) do, in fact, involve some policy questions, and they have led to different sets of specific proposals. Although I personally have my own favorite answers to these various questions, any proposal that is carefully worked out should be able to improve upon the present situation to the reasonable satisfaction of those who are interested.

THE ORPHANS DEDUCTION

The orphans deduction was enacted in 1976 and is a rather civilized innovation in our estate tax. Unfortunately, however, the legislation included conditions for qualification that, with some modifications, parallel the terminable interest rule of the marital deduction. In this situation, neither revenue nor any other policy is at stake that justifies even the existence of detailed qualification rules, which turn out to be complex, treacherous and unduly burdensome even for planning the simplest of small estates.

There are two reasonable alternatives: (1) simply grant an increased exemption to an estate based merely on the existence, number and ages of qualified orphans, without regard to the nature of the decedent's dispositions; or (2) if it is really felt necessary to require the deductible property pass in some qualifying form to an orphan, it should be sufficient that the arrangement make any substantial provision for the orphan (and examples can be put in the legislative history). Also, the underlying reasons for the deductions would suggest it should be available even though a spouse survives (except so far as mooted by an unlimited marital deduction).

The importance of doing something to remove the totally unnecessary qualifying requirements can readily be illustrated in two ways. First, at a cost in staff time that must already outweigh the foreseeable risks, the Joint Committee Staff has attempted both initially and again in the 1978 Act to develop rules that would make perfectly wholesome forms of family trust arrangements (so common in traditional planning for the possibility of parent's simultaneous deaths) eligible for the deduction—but with dismaying lack of success; I was told by a high level Treasury spokesman who had telephoned me on another matter, but with whom I shared my strange mixture of laughter and tears over this matter, that he agreed that there was no need for imposing troublesome qualifying requirements in this area but that the Joint Committee staff was dealing with that matter. The government's overinvestment in this problem has only begun, inasmuch as the more elaborate work of writing regulations will not be undertaken until the staff investment in statutory language has been completed. Second, on the private side, the importance of this question can already be seen in the understandable and widespread overreaction of lawyers who are prepared to ask for repeal of the whole deduction in order to get off their backs and out of the client's wills (and bills) what turns out to be a very troublesome planning and drafting problem (involving both the formula amounts and the terminable interest concerns of marital deduction provisions) to deal with a situation that is unlikely to arise and with modest sums at stake but which most feel cannot ethically be ignored so long as the deduction is in the statute. I do not feel so hopeless about the orphans deduction if a real new start can be made, but I (who advocated this deduction in 1976 testimony before the Ways and Means Committee) will join those who have already given up the faith (see e.g., Statement of Frank Berall, this panel) if the only alternative is for the staff to again attempt to patch up an inherently defective solution to a virtually nonexistent problem.

THE DISCLAIMER STATUTE

Section 2518 was enacted in 1976, ostensibly to bring some uniformity and certainty to an area where this was needed. Some believe federal legislation was not needed, but I personally do not agree—especially if the legislation has stuck to the problems it was ostensibly addressing and had not snuck in provisions to cover other and most dubious concerns of the IRS. What we did not need was a new definition of a "qualified disclaimer" that would undercut prior concepts and also sound and socially desirable post-mortem planning. The statute was drawn almost punitively, as if there were legitimate concerns and as if revenue were at stake. All that is needed in order to make the statute workable is: (1) to make it clear again (as it was clear in the past) that the timely renunciation or a general power of appointment does not constitute a release or otherwise a transfer of the appointed interest; and (2) to remove subparagraph (b)(4) of the statute, which is an undesirable provision which has already been amended (inadequately) in 1978 and which is about to become the source (in an effort to narrow the amendment arbitrarily) of a regulation that has no reasonable foundation in tax policy.

In short, if a disclaimer is made in a timely fashion, without qualification and without accepting any of the benefits of the interest or power disclaimed, that interest or power should be treated as if it had not been created. The present rule places an unrealistic, unwarranted and excessive demand for wills to be kept updated and to be perfected before a testator's death, at the expense of traditional and socially desirable post-mortem opportunities for adjustments to be made (with some but not all benefits being retained by one who wished the lesser benefits). The primary impact of the provision I have suggested be deleted is to require regular (and virtually mistake-free) review and updating of wills to respond to frequently overlooked changes of circumstance, even on one's deathbed, under the threat of unwanted and potentially adverse results that previously could have been avoided by prompt post-mortem evaluation and action. The objective of my proposal is simply to allow to be done, when necessary, by simple post-mortem actions that which is not prohibited or disfavored in principle, for the decedent could have maade the adjustments in his will had he had foresight—and time—to do so. That is, we should treat the results of timely, unconditional disclaimers as if the results had been accomplished by the testator himself.

To put the net effects of the objectional provision (§ 2518(b)(4)) in another way, it requires that a seriously ill property owner see his lawyer before seeing his doctor, if he wishes his family to receive the same treatment that is perfectly permissible for other families under an updated will. I do recognize that in some circumstances results must inevitably turn on how a property owner's affairs have been planned, but this does not mean that we should accept such situations where not necessary or dictated by valid tax policy considerations. The fact that occasional disparities in the treatment of people similarly situated are inevitable does not require that we accept it where it can readily be avoided.

THE P.P.T. CREDIT

I have some suggestions to make with respect to the credit for property previously taxed. This credit presently applies without regard to the generational relationship between the transferee and the decedent and is so designed as to decline 20% every two years and to expire after ten. Thus, the average woman who outlives her husband (by just over ten years) loses the entire credit, and the average widower (by surviving just over six years) loses most of it (60%). Unless a 100% marital deduction enacted (which would eliminate the interspousal need for this credit) consideration should be given to retaining a full credit and giving it an unlimited duration with respect to the estates of surviving spouses, or possibly even the estates of all members of the transferor's and higher generations. On the other hand, I do not believe that the PPT credit should continue to be available at all to younger generation transferees, even on the declining basis.

GENERATION-SKIPPING: NEW CHAPTER 13

The new tax on generation-skipping transfers is based on an intricate but I think inevitably complex set of provisions. Unlike the carryover basis rules under which complexity increased as one's mastery of the statute increased—the sign of a fatally defective concept—Chapter 13 does become easier to handle and live with as our understanding of it improves. I personally believe it was, though painful, an essential reform if we were to have a sound transfer tax system. In fact, I would have preferred that some of its more lenient provisions had been omitted.

Nevertheless, these "weaknesses" (as some may see them) are a part of chapter 13 and should be accepted in the regulations. There is already solid basis for believing that arbitrary distinctions and fine lines are being drawn administratively that are justifiable neither by the legislative language and history nor by legitimate policy considerations within the presently given context. The whole area is so new and so significant in the long run that I urge Congress to maintain a continuing interest in this part of our transfer tax system. This broad, novel legislation offers many opportunities for ill-conceived regulations or rulings to create situations that will give rise to inequities among similarly situated taxpayers, and thus horribly complicated planning problems—or opportunities. If, for example, the underlying purposes of the so-called "grandchild exclusion" and its qualifying requirements are not kept in mind and if regulations can pose technical requirements beyond what is appropriate to safeguard those policies, we will have situations in which qualification depends on the alertness, expertise and luck of the draftsman, when legitimate policy considerations would not justify having the result turning on such a specific provision or detail of draftsmanship.

The regulations should a proper concern for the fairness as well as the integrity of the system, and this means that regulations and rulings should not attempt to trap a taxpayer and grab a tax dollar any time it is possible to do so without the regulation being in flagrant disregard of the clear language of a statute. This may be an exaggerated but not totally paranoid characterization of some of what we have been seeing recently in regulations and rulings. In developing the rules of the game, as distinct from the inevitable adversariness that arises in attempting to enforce those rules, it is important to guard against even an understandably adversary outlook in order to assure the long-range quality of the system. I hope that proposed administrative interpretations will not continue to offend even those of us who are basically believers in this new tax. Congressional interest and watchfulness, however, may be particularly important in this significant, developing area of the transfer taxes.

Senator BYRD. At this point Senator Nelson is in route from the airport and will be here very shortly. The committee would like to delay the hearing of the next panel if it's convenient to the two panelists until about quarter of 1 so that Senator Nelson would have an opportunity to be here when the panelists begin.

With that in mind, the committee will take a short recess until say 20 minutes of 1.

[A brief recess was taken.]

Senator BYRD. The committee will come to order. There was a brief recess. At this point I'll call on the distinguished Senator from Wisconsin, Mr. Nelson. Senator Nelson is the chairman of the Small Business Task Force, which was appointed by the majority leader of the Senate to consider the recommendations of the White House Conference on Small Business. Senator Nelson was instrumental in arranging for the meeting today. Today's meeting and two subsequent ones will consider various proposals recommended by the White House Conference on Small Business.

Two measures before the committee today have been introduced by Senator Nelson, S. 1825, introduced by Senator Nelson for himself, Mr. Pell, Mr. Roth, Mr. Cranston, and Mr. Packwood. S. 2220 was introduced by Senator Nelson for myself, Mr. Baucus, Mr. Heinz, and Mr. Stewart.

The committee had earlier under discussion, or still has under discussion for that matter, S. 1984 introduced by Senator Wallop and Senator Thurmond.

Senator Nelson, you may proceed as you wish.

Senator NELSON. Thank you, Mr. Chairman. All of us appreciate your being willing to take the time to schedule hearings on these important measures that are pending before your subcommittee.

Mr. Wolf, Steven Wolf, is here today on behalf of the National Family Business Council. Mr. Mark Burrell, who is not here today is from Green Bay, Wis. He is past president and a current member of the board of the National Family Business Council, which has a great interest and concern over the question of estate taxes and family enterprises. I believe we all share that concern and recognize that we have a responsibility, in my judgment, to be sure that the tax laws and inheritance laws and other matters within our jurisdiction are designed in such a way as to encourage and help preserve family enterprises within the family.

Mr. Chairman, I apologize for being here late today. I had a previous schedule in Wisconsin and didn't return until 12 today.

In order to economize on time I think I will just ask that my statement be printed in full in the record as though read and then we can move to admit the witnesses who have come some distance in order to present their views.

[The prepared statements of Senators Nelson and Dole follow:]

Statement of Senator Gaylord Nelson

Mr. Chairman, I wish to commend you for your foresight in holding today's hearing to consider three major legislative proposals to reform the federal estate and gift tax laws.

As you know, I introduced the National Family Business Preservation Act of 1980 on January 24. This measure, S. 2220, is cosponsored by Senators Baucus, Heinz, Stewart, Leahy, Durkin and Boschwitz.

At the White House Conference on Small Business, 1,625 delegates from every state in the nation voted as their third highest priority the preservation of the family-owned business. The proposal was developed as a result of, and in response to, the Conference directive. It is designed to ease the tremendous burden federal estate taxes impose on many independent family-owned business and farms. By reducing that burden, this measure will allow an entrepreneur who has devoted a lifetime to building an independent enterprise the opportunity to pass the business on to his children.

This proposal would change current federal estate tax law so that up to one-half the value of a family-owned business or a maximum of $500,000 would be exempt from tax. An heir would earn a five percent ownership interest for each year he or she worked in the family business. An heir could accumulate a maximum 50 percent ownership in the business, not to exceed $500,000 in value, by working 10 years in the business. In order to qualify for the exemption at all, family heirs would be required to actively work in the family business for a minimum of five years following inheritance of the business.

The concept of this legislation deserves the careful consideration of the Finance Committee. I realize, however, that technical changes and modifications to various provisions in the bill may be necessary. Therefore, I look forward to reviewing the testimony of today's expert witnesses. I welcome any productive suggestions they may have for improving the measure.

Today's hearing will also focus on two other proposals which I have sponsored.

The first measure, the Estate Tax Adjustment Act of 1979, is cosponsored by Senators Pell, Roth, Cranston, Packwood, Melcher, Thurmond and Jepsen. This bill, S. 1825, would increase the exclusion from federal estate tax to the equivalent of a $250,000 exemption. Under current law, the estate of a decedent dying after 1980 is entitled to the equivalent of a $175,000 exemption. The current exemption is totally inadequate in light of our double digit rate of inflation. For example, it is fairly common in my own State of Wisconsin for a small family-owned farm to be valued at well over $200,000. Values of $400,000 and over are also easy to find. The owners of these farms are not wealthy individuals. Many of them have never earned more than $15,000 to $20,000 a year in their lives. The only reason their farms are valued so high on paper is because of inflation. And this is another nail in the coffin of the family farm in America. When the owner of a family farm dies it is extremely difficult for his or her heirs to retain the farm in the family. Because of the inflated value of the farm, the estate is "paper" rich and subject to a potentially stiff federal estate tax. In many instances, the heirs simply cannot pay the tax and are forced to sell in order to do so. I believe an increase in the estate tax exemption to $250,000 is a modest, but necessary step in alleviating the cruel burden inflation has placed on not only these estates but the estates of all Americans.

I am also pleased to have joined Senator Wallop in cosponsoring the third bill to be considered today. This proposal, S. 1984, would effectively eliminate federal interspousal transfer taxes. Essentially, it would create an unlimited marital deduction for purposes of computing federal estate and gift taxes. This measure is long overdue. It recognizes once and for all the contributions a wife makes to the accumulation of a family's wealth. Until now, the wife who has worked side-be-side with her husband on the family farm or small business has been virtually neglected in terms of her economic contribution to the success of the enterprise. When her husband dies, the entire value of the farm or business may be included in the husband's estate and a significant estate tax may be imposed.

Two years ago, Congress passed a measure I introduced which reduced the estate tax burden for these widows. The proposal was enacted as part of the Revenue Act of 1978. It provides that a spouse who has materially participated in the family business or farm will be considered the owner of up to 50 percent of the enterprise for federal estate tax purposes. A wife will be considered to have earned an ownership in the enterprise at the rate of two percent for each year of work. Thus, after 25 years, a wife will have achieved a maximum 50 percent ownership interest. S. 1984 is a natural extension of this proposal. It recognizes the contributions of not only working wives but also the spouse who stays at home and takes care of the children and performs all of the necessary tasks which enable her husband to earn his living. The old saying that behind every successful man there is a good woman is more valid than ever before. This bill reflects that fact.

Taken together, the three bills under consideration today are designed to prevent the federal estate tax law from falling further behind due to inflation. These proposals will make it easier to preserve family ownership of business from one generation to another. The adjustments are meant to leave the family farmer, the independent business person and the surviving spouse in the same position they would have been in if inflation has not intervened.

We all hope that inflation can be brought under control. But, even if we reduce the rate of price increases in the future, we must still deal with the inflation that has already taken place. I believe these proposals are moderate, reasonable and sound steps in dealing with the problem.

STATEMENT OF SENATOR DOLE

Mr. Chairman, the Senator from Kansas is pleased that you have provided the opportunity for public discussion of the important issue of estate and gift tax revision. This is an area involving several of my greatest concerns regarding federal taxes.

First, I have sponsored with Senator Percy, S. 1859, which would guarantee that crop share rentals may be used in the formula method for determining the current use value of qualified farm property. I believe the hearings on S. 1859, held on March 4, were very informative. This is a subject of great importance for the continued viability of the family farm and I am gratified that Senator Wallop's bill, S. 1984, contains a similar provision and hope there will be further discussion of the issue at this hearing.

Second, I have long been concerned about the increased burden of Federal taxes upon the people of this country resulting from inflation. The adverse impact of inflation is not limited to income taxes, but also affects other taxes with a progressive rate structure such as the estate and gift tax. I welcome the opportunity presented by this hearing to obtain further information on this issue.

Finally, it is obvious that there is a great need for simplification of the Internal Revenue Code. The estate and gift tax contains many traps for the unwary and is ripe for review with a goal of providing equitable, understandable rules on which taxpayers can rely to plan their affairs. I believe discussion of the bills which are the subject of this hearing today will provide an opportunity to focus attention on the need for simplification.

Mr. Chairman, I look forward to receipt and consideration of the testimony which we shall hear today.

Senator NELSON. I'd like to say just one word, however, to Mr. Wolf. I've gone through your testimony and I think you have some very good suggestions for improvement in the legislation that we introduced. And of course that's the purpose and function of these hearings, to give an opportunity to those who are knowledgeable about the subject matter to analyze proposals and make suggestions for their improvement.

As you know we drafted this legislation based upon the general endorsement of the concept by the White House Conference. Thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Nelson.

The panel consists of Mr. James Powell, tax committee chairman, National Cattlemen's Association, and you have with you, Mr. Powell?

Mr. POWELL. Bill Jones of the staff of the National Cattlemen's Association.

Senator BYRD. And Mr. Stevan Wolf of the National Family Business Council, and you have with you?

Mr. WOLF. Harry Jacobs, president of the Harry Jacobs & Associates, Inc. out of Buffalo, N.Y.

Senator BYRD. Thank you. Who would like to proceed first?

STATEMENT OF STEVAN A. WOLF, PRESIDENT, NATIONAL FAMILY BUSINESS COUNCIL, ACCOMPANIED BY HARRY JACOBS, PRESIDENT, HARRY JACOBS & ASSOCIATES, INC.

Mr. WOLF. Thank you very much, Senator Byrd and Senator Nelson. My name is Stevan Wolf. I'm the general manager of the Letty Lane Co. in Westville, N.J. I'm a third generation of Wolfs that have been in the candy business since 1945. We're manufacturers and wholesalers of various candy products.

I'm also the past president and current government affairs chairman of the National Family Business Council, trustee of the National Small Business Association, and the NFBC representative on the Small Business Legislative Council.

With me today, as I said, is Harry Jacobs, who's president of the Harry Jacobs & Associates Co. out of Buffalo, N.Y., and they're primarily business consultants on business continuity.

Also I'd like to point out that Mr. Jacobs was a former middle linebacker of the Buffalo Bills during the world champion 1964–1965 seasons.

Senator BYRD. We don't want to get mixed up with you too much.

Mr. WOLF. It's very nice to have him here with me because Harry and I worked together since Harry's a member of the NFBC and also on the legislative council committee with me, and he's worked directly with me in preparing this statement.

The entire membership of the NFBC also wishes to thank and compliment Senator Nelson, as well as the other cosponsors, Senators Baucus, Heinz, and Stewart, for introducing S. 2220. We also appreciate the foresight of the Senate Finance Subcommittee and in particular Senator Byrd, who understands the problems of family businesses, for scheduling the hearing at this time.

The National Family Business Council, for your background, is a nonprofit membership association that was chartered to promote the interests of family business in the United States with all members of the council active family business people. Unlike other trade associations, we do not represent one industry grouping, nor are we primarily a lobby or special interest group. Rather, our member base is widely divergent, drawing representatives from a variety of manufacturing, wholesaling and retailing firms, as well as some of the professions.

At this point I would like to vary from our prepared text that will be put into the record and try and summarize some of the points that we have here to explain the constructive criticisms that we had entered, that Senator Nelson also mentioned.

In addition to that, I think Harry would like to comment on some of the activities and other testimony that was made this morning.

Also, in addition to the legislative issues that the NFBC has, we sponsor seminars and workshops aimed at providing a forum for the exchange of ideas and information relating to problems common to the family business community. With over 10 million family firms in America, we are the only organization devoted specifically to the betterment of family enterprise.

We also recognize that out of the hundreds of issues that the White House Conference of Small Business elected as their priorities, we were fourth among the top 20, only 20 votes short of second. And I think that gives a very strong indication of how the small business community feels about the estate tax issue and the changes that are needed.

Because of that, Senator Nelson and his staff demonstrated their commitment and sensitivity to the small business community by introducing S. 2220 on January 24, 1980, just 7 days after the closing of the White House Conference.

In reviewing S. 2220, I'd like to review some of the points that we felt would enhance the objectives of the bill and go a lot further in accomplishing the goals of perpetuation of family business in this country.

Under section (b), the limitations and the 50-percent exclusion, we feel that the 50-percent exclusion is fully acceptable, but a definite clarification has to be made as reference to section 2040(c), joint interest of the Internal Revenue Code. It should be clearly stated that the qualified recipient, the child of the decedent, and the spouse, are each entitled to a separate application of this section with only the spouse required to include section 2040(c) in the aggregate value of his or her reduction of the decedent's gross estate.

This would definitely clarify the problem that we had in determining where the aggregate total came from.

Under section (b), the limitations and aggregate reduction, we strongly feel that the $500,000 limit is inadequate as an inducement to perpetuate family business. The National Family Business Council, based on a poll of its members, firmly believes that there should be no imposition of estate taxes on business assets that are transferred to qualified recipients.

In its entirety, the estate tax represents such a small segment of the total revenue that was brought out earlier this morning that we feel that the jeopardy that it puts the family business in is something that should not be considered in the estate tax law, thus allowing the family business to pass on without having problems with the estate tax law and planning for it.

If you take the anticipated loss to the Treasury, which was $0.2 billion of revenue, it represents such an insignificant amount of percentage that it's less than one-one thousandth of 1 percent of the total Federal budget. And this just goes further in explaining the fact——

Senator NELSON. Could I ask a question, Mr. Chairman?

The Treasury's estimate was an estimate based on what?

Mr. WOLF. Their estimate was $200 million loss, $0.2 billion in the first year, or every year, due to these changes.

Senator NELSON. Under the provisions of this bill?

Mr. WOLF. Yes.

Senator NELSON. And did they have an estimate of what the loss would be if you had no tax at all?

Mr. WOLF. No, just on the estimates on this bill it would be a $200 million loss of revenue each year. We feel it's so insignificant that the specific tax on the business property should be eliminated.

In addition, the gains that were made in the estate tax treatment as a result of the Tax Reform Act of 1976 have basically been wiped out by the inflation over the past 3 years. With the increasing trend toward merger and economic concentration in the United

States, major changes in the estate and gift tax treatment are needed to insure the continued independence and competitiveness of the small, private sector of our economy.

We fully and somewhat regretfully acknowledge the fact that to eliminate the estate tax on the business entirely is probably something that will not be immediately accepted. Based on that fact we would feel that $1 million ceiling or limit would be a first step toward the eventual elimination of the tax. So we would like to see the change from $500,000 on the limit be made at least to $1 million, thus allowing both the spouse and the heir apparent, as long as he's materially participating in the company, to have the opportunity to have this reduction in the value of the estate.

Senator BYRD. Let me see if I understand. You would change the $500,000 to $1 million?

Mr. WOLF. Yes. We feel that that is a very important consideration because $500,000—as a matter of fact, if I may use your example of the inflation on your house, the inflation that has caused the increase of your house to go from $40,000 to $250,000 or whatever the example was, just put that into the same consideration for a family business, that you know, was once a very small part of—it could be a very small part of the estate, depending on the size of the estate, but I know the value of our business has jumped up tremendously over the past 5 or 6 years, and that $500,000 limit on the business is not going to mean anything. The property alone will be more than that.

Senator BYRD. Inflation is pushing the value constantly upward.

Mr. WOLF. Right. Therefore, as a first step, the $1 million limit is significant to have any effect on the business at all, because of the inflation rate, not only specifically the business but the property alone that would be involved with a business.

Senator BYRD. Leaving businesses out of it, although we're talking about business at the moment, just a home that's valued today at $70,000, with a 9-percent inflation rate, which is one-half the rate we've got now, over a period of 20 years, that home would be valued at $421,000.

So I think that dramatizes, along with the testimony that you're giving, dramatizes the need to do something about changing the estate tax laws.

Mr. WOLF. Let me clarify this position by stating that later on in the presentation I talk about separating the business and personal assets of one's estate. That could definitely simplify the problem that we're having with perpetuation of family business. Not only will inflation increase the value of the family business, but you're actually putting a burden on the family business for the entire estate and you know, we're in a situation—you know, I'll be 35 this year, and to pass on the business—I'm the third generation—to get it to the fourth generation is going to be an astronomical problem. My son will be 3 this year and by the time he's ready to get into the business, besides the fact that we're having enough struggles as it is just dealing with the 1980's, I have a tremendous problem giving him the business without having the estate tax law completely wipe us out because of the inflation rate and many, many other factors.

This is something that's very important to us. So a $1 million limit is just a first step. There has to be something built into this so that later on, as the values continue to increase, the limit continues to increase to the point where maybe estate tax should be completely eliminated from the business assets of one's estate, of the business property, which is what we feel has to happen so that the business can pass on from generation to generation. And I'll get into that a little bit later.

Later on in the bill it talks about 2040A property as "any interest in a real or tangible personal property." Here the words "tangible personal property," by definition, clearly excludes goodwill and might exclude the value of patents, copyrights, exclusive contracts, exclusive territories, et cetera, et cetera.

We think that the term "tangible property" should be removed because if you get into a case where you have a franchise and you're passing on the franchise from one generation to the next, goodwill is a significant part of that franchise, in particular a McDonald's-type franchise, where this is where the whole value of the estate comes from.

So we feel that tangible should—to include in tangible property that's all included in the value of the estate, the business property of the estate.

Under the proposed law these items could not be taken into account for section 2040A reduction purposes. However, they still would be considered by the Internal Revenue Service for inclusion purposes.

Therefore, both tangible and intangible must be considered under 2040A. The key is not what passes but what is included in the gross estate.

Next, under section (c)(1), it limits the deduction only to cases where the farm or other business interest passes to a surviving spouse or any child. This particular section should be expanded to include all those who are covered under the attribution section of code 318. And of course this would add parents, spouses of children and grandchildren to the surviving spouses and children. Therefore a son-in-law could very easily get involved with qualifying for this reduction in the value of the estate.

To limit it only to the spouses and children, I think you're narrowing down the opportunities that one has to pass on the business from generation to generation, specifically if those spouses and children are not interested in the business but maybe a son-in-law is.

Section (c)(2) which defines the 2040A value of the interest with regard to this section by reducing the 5 percent of the taxable year, of each taxable year a qualifying heir materially participated in the farm or business, is specifically in question.

I think earlier in the discussion this morning there was some reference being made to the fact that the property itself should not have—there should not be a tax—I'm trying to understand the technical part of this, which is really not my forte, but if I understood the testimony this morning, they were referring to not having a qualified recipient who had materially participated in the business. Therefore, there could be a tax break for an individual who does not work in the business but owns the business and can hire someone to work in the business, therefore carrying on the family business but not doing it himself.

And the National Family Business Council is very specific in this area. We feel, No. 1, that the heir has to work in the family business in order to effectively carry it on. He has to materially participate in the business on a regular basis. Obviously, all those who are in our organization work on a day-to-day basis, and this is very important. And if the qualified heir is there in the business, whether he works before, during, or after death, he should have the opportunity to receive the full 50-percent reduction up to the limit established by the fact that he's willing to take the business and carry it on in the future.

This is what's most important to us. We're not interested in who works basically before, but who's going to carry on the business afterward. This is what's important to us.

So we strongly urge you to give us the 50-percent reduction with the full recapture of the tax available if he doesn't carry the business on for 5 or even 7 years.

Senator NELSON. Does or does not?

Mr. WOLF. He should get the full 50 percent irregardless of whether or not—he should get 50 percent full reduction on the value of the estate if there's a qualified heir working in the business, if he works in the business during the taxable year of death, which indicates that if you had a father who passed away and the son came home from college and went to work, he should qualify for the full 50-percent reduction.

Senator NELSON. In how long a period of time?

Mr. WOLF. He should qualify immediately, and if he doesn't carry the business on for 5 or 7 years thereafter, full recapture should be made. I think the point I'm trying to make is that it's not so important that the business have a qualified heir in the business before the decedent passes away but afterward, to carry it on.

So if there's a qualified recipient available to come back and work in the business, that business or the estate should receive the full 50-percent reduction or the recapture available if he doesn't carry the business on for 5 or 7 years.

I think at this point rather than allow me to go any further with some of the technical aspects, if it's all right with Senator Byrd I'd like to have Harry Jacobs get into some of the sections that he's more qualified to deal with on a technical basis, and we'll run a little bit over our time if that's OK.

Mr. JACOBS. Is that all right?

Senator BYRD. Yes. Don't go too far over the time.

Mr. JACOBS. OK. I just have a couple of examples I think of very real people that I represent from western New York where this bill that Senator Nelson has placed in would definitely aid in continuing the business. I wanted to share those with you and also a couple of thoughts on what I think would be some of the potential negatives that might be proposed toward enacting this legislation.

Comment on the loss of revenues to the Treasury—they've done the study so I'm sure that that's actual facts, that the $200 million is expected loss to the Treasury revenues from estate taxes, but I think the thing that it doesn't take cognizance of is the fact that the continuity of that business does continue jobs. It does continue people earning a living paying income on x revenues. The corporation itself continuing to run and pay corporate tax, which are revenues. And it also would take—that business continuing would keep people off of transfer payments, which is the opposite of revenue to the Government, but cost to the Government.

So those things are not taken into consideration when somebody says it's going to cost the Treasury $200 million in revenue.

I think the focus of our bill, as Steve has well stated—or Senator Nelson's bill and as we observe it, is that the future of our American free enterprise system is really based upon the small business, and continuity of those small businesses is what we would like to see the focus of our conversation focused upon.

Some people say that 6166 and 6166A of the Revenue Code, as was mentioned earlier this morning, is a solution to that problem. I have an attorney on my staff in Buffalo who was with the Internal Revenue for 13 years, was a senior estate tax attorney. And his experience is that that is hardly ever used. It's just not an effective means of solving that problem.

Another solution they say, well the business could buy life insurance. Well, I started out in the life insurance business in 1962, and it does do a great job for different problems, and that's one of them, but one of the big burdens that our small business people face today is the ability to raise capital, and any dollar spent on insurance is capital dollars because those premiums are after-tax dollars.

Four quick examples of actual real people in western New York, three of them the proposed legislation would aid in business continuity, the fourth it wouldn't because the father is dead and they already had to accomplish what was necessary to solve the problem.

First example, the business started in 1920; 110 jobs are involved right now. The grandfather willed the business to a father. The father is now 64 and uninsurable. Two sons in the business, 38 and 34. The father is now making, the 64-year-old, $38,000 a year, so you know that he's not been—and that's the highest salary he's ever taken in his history in the business—so you know he's not taking all the money out of the business.

When we started working with him and showed him what the liability of his business and his estate was and on his wife's death, it was $350,000 on his death and $350,000 on his wife's death in order to pass that business on to the two sons. His comment to me—now remember, this is a gentleman that's worked all his life in this business, the highest salary he's ever taken is $38,000—his comment to me was "Give me the $700,000 and let the Internal Revenue take my business." Because he never in his life had seen $700,000, but that's the actual cost of continuing that business.

This doesn't seem to me, as a man working with that person, a just reward for having worked all of his life, produced 110 jobs, which was the mainstay of a small western New York community. And the people that I do work for and represent aren't the wealthy 4 percent the Treasury talks about when saying that the bills that are out here now are only going to affect the top 4 percent. They are the hard-working, the middle class, the work ethic type of people.

Same type of situation occurring in another business where the father is trying to pass it on to his sons in the business and is unable to.

To go on to conclude, to one that's already transpired, a family whose business again was owned by a father, wanted to pass it on to his son-in-law, who was a key person in the business. When he died, in order to take care of the taxes and cost of transferring that business on, the family is now out of control of the business.

So a father again worked all of his life to build a business, to produce jobs for State and Federal tax revenue, and in the end result was unable to accomplish what he wanted to with his job.

I think again just to summarize the focus of what we see the National Family Business Act doing and accomplishing is enabling this act to solve a portion of the problem of job creation. If we, with the estate tax system, cause businesses to fold or be purchased by conglomerates, we get into the problem of eroding of base of jobs in this country. We have a job creation problem right now, and I think this will aid us in continuing the base.

Senator BYRD. Thank you, sir.

Senator Nelson?

Senator NELSON. I have the Internal Revenue Code before me and I am looking at the estate tax section of the code. I notice that at $5 million of taxable income the tax is $2,550,800 plus 70 percent of the excess over $5 million.

I believe the unified estate and gift tax schedule was adopted in 1976. So I would like to examine the schedule to determine what it was back in 1940. There have been some adjustments made since that time.

Now suggestions have been made for modifying this proposal. Some of these suggestions for amendment might be the kind that might very well be supported by Treasury.

For example, one suggestion is that there be a requirement that the deceased owner must have owned the business at least 5 years before death. The obvious thing here is to prevent, I assume, somebody in anticipation of death, 1 year or 6 months before, simply buying some business for the purpose of avoiding a tax. Do you have any comment on that?

Mr. JACOBS. I guess my comment as a business consultant would be just the focus of the question. The focus of the question is pointing toward a tax evasive method of continuity of the business so that you achieve a tax savings. The focus of what we're looking at and I think would be the proper focus of the question would be the continuity of that business and thereby how the qualified heir would have to be involved in that to continue the business. If that qualified heir did not continue that business for a period of time after the fact, then I would agree.

We're looking at two different things. The question there I think is looking at the tax evasive method of doing that, while what we're really looking toward is a method to develop business continuity. I don't know if that answered your question.

Senator NELSON. Well, are you saying you wouldn't want any requirement of prior participation?

Mr. JACOBS. Not on prior but after because we feel definitely there should be business continuity.

Senator BYRD. Senator Nelson, I wonder if we should hear from Mr. Powell so that he might participate in the questions.

STATEMENT OF JAMES L. POWELL, CHAIRMAN, TAXATION COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION, ACCOMPANIED BY BILL JONES, NATIONAL CATTLEMEN'S ASSOCIATION

Mr. POWELL. Thank you, Mr. Chairman. I'm a cattleman from Texas. To my right is Bill Jones with the staff of the National Cattlemen's Association.

The National Cattlemen's Association strongly supports the concepts contained in S. 1984, S. 1925, and S. 2220. These bills recognize the urgent need for amendments to the estate and gift tax laws as they apply to the family-owned farms, ranches, and other closely held businsses in order to correct certain gaps and oversights which occurred in the 1976 Tax Reform Act and the 1978 Revenue Act and to resolve issues which have developed as a result of Treasury's interpretation of certain provisions of these acts.

Senator Harry F. Byrd, Jr., chairman of this subcommittee, recently observed the necessity for such amendments by stating that the "estate tax is often levied at the precise time that a family has lost the principal wage earner and is undergoing a great financial upheaval. The same holds true for the family business which cannot rapidly recover from the loss of key personnel. If these considerations are not taken into account in the judicious administration of the estate tax, havoc may be wreaked upon the family and small family-owned and operated businesses may be forced into liquidation."

National Cattlemen's Association urges adoption of these provisions of S. 1984. It endorses S. 1825 and also supports the concept contained in S. 2220.

NCA recommends and commends Senator Wallop for his introduction of S. 1984 and feels enactment of this bill with certain modifications and additional provisions would be most beneficial to the whole agricultural community, as well as to other closely held businesses. Further, NCA wishes to commend Senator Nelson for his introduction of S. 1825 and S. 2220 and also Senators Pell, Roth, Cranston, Packwood, Melcher, Thurmond, and Jepsen for their sponsorship of S. 1825 and Senators Baucus, Heinz, and Stewart for their sponsorship of S. 2220.

Now Mr. Chairman I would like to comment specifically on some of the provisions of these bills, taking first S. 1984. This bill contains a number of provisions which would be extremely helpful to family-owned farms, ranches, and other closely held businesses. NCA feels that some modifications and additions to this bill would be a benefit and would carry out its intended purposes.

One, the unlimited marital estate and gift tax exemption. NCA strongly supports this unlimited marital deduction and feels that it would be most beneficial in all situations, but particularly with respect to transfer of farms and ranches between spouses, either during the lifetime or death. It is the position of NCA that transfers between spouses are not an appropriate time to impose a tax, since there are reasons to maintain the family unit and family business to provide needed continuity. Examples are given in the written statement.

Second, the amendments to special farm use valuation provisions. A number of amendments are made by S. 1984 to the farm use valuation provisions, which was added by the 1976 Tax Reform Act. Elimination of the $500,000 reduction—this limitation is not explained in the committee reports and is contrary to the stated congressional purpose of providing much-needed estate tax relief to family farms and ranches and encouraging the family ownership and operation of farms and ranches.

On a national basis, the value of an average sized farm has more than doubled since 1972 and further appreciation in farm land values is anticipated. This is demonstrated by the fact that in 1950 the average value of farm assets per farm was $23,400. In 1978, this average per farm value had increased to $250,000.

Senator BYRD. From $23,000 to $250,000?

Mr. POWELL. From 1950 to 1978, yes.

Senator NELSON. This is the average value of what?

Mr. POWELL. Farm assets.

Senator NELSON. When you say farm assets——

Mr. POWELL. Per farm. That includes the land and the machinery.

Senator NELSON. Went from what figure to what figure in what period of time?

Mr. POWELL. In 1950 the average value of farm assets per farm was $23,400, according to the USDA's manual published this year. It's handbook No. 551.

Senator NELSON. And then that went up to what?

Mr. POWELL. It went up to $250,000 in 1978.

Senator NELSON. This is the average?

Mr. POWELL. This is the average.

Senator NELSON. Isn't that likely to be misleading in the sense that you aren't talking about the same size farm. You aren't saying that a farm of 200 acres was worth $20,000 in 1950 and is now worth $250,000. You're probably talking about—in that period of time, for example, in my State, from 1952 to date, the number of dairy farms has dropped from 132,000 to about 55,000. They're producing just about the same amount of milk with less cows. What's happened is the farms have gotten larger in size.

Now if that's the case with your statistics from USDA, they would need some qualifying, wouldn't they?

Mr. POWELL. Well, the farm has increased in size to today's average of about 440 acres.

Senator NELSON. What was the acreage size in 1950?

Mr. POWELL. About 276 acres.

Senator NELSON. 276 acres. OK, so they are comparing a 276-acre farm to today's 440-acre farm?

Mr. POWELL. 440 acres.

Senator NELSON. All right.

Mr. POWELL. Should this same trend continue, the average per farm value in 1983 will be over $500,000 and will exceed $2,400,000 by 2005. Sufficient restrictions are contained in section 3032A to limit the benefits of the provisions to estates of family-operated farms and ranches. Thus, the $500,000 limitation serves no useful purpose and is in fact detrimental to estates of deceased farmers and ranchers.

For these reasons, the provision of S. 1984 to eliminate the $500,000 limitation is strongly supported by NCA.

Removal of a material participation test. A major problem has been created under present law by the predeath material participation requirement. This is because farmers and ranchers who materially participate in the operation of all or a significant portion of their farm or ranch may be subject to self-employment tax on the earnings from the business and also might forfeit social security benefits to which they would otherwise be entitled.

The result is that in many cases farmers and ranchers will be forced to decide whether they want the benefits of farmland valuation for their estates or whether they would rather receive full social security benefits and not be subject to self-employment tax on certain of their farm earnings during their lifetimes. Such a choice is unfair and certainly was not the intent of Congress in passing the farmland valuation provision.

Problems are also raised by the requirement that there must be material participation by the qualified heir after the decedent's death. For example, an elderly surviving spouse may be physically unable to materially participate in the farm or ranch operation. A similar situation could occur with respect to minor children who inherit the farm or ranch.

Additionally, in many situations a farm or ranch will not support more than one family unit at a time.

In response to these problems, S. 1984 would eliminate the material participation requirement entirely. At the same time, S. 1984 would modify the threshold qualification test. NCA supports the concept of modifying the material participation test to make it workable in light of the problems previously cited. However, NCA feels there are sound and compelling reasons for retaining some form of active involvement or participation requirement by the decedent or by members of his family and by the heirs or members of their families.

NCA urges consideration be given to substituting some form of active involvement or participation requirement for both predeath and postdeath material participation under existing law so that the ills which presently exist under the material participation standard of section 2032A will be cured.

Additionally, NCA feels that the 65-percent rule of S. 1984 could pose problems to some farm and ranch estates in qualifying for section 2032A treatment. This could happen, for instance, where an elderly farmer or rancher sells a portion of the farm or ranch to younger members of the family and takes back a note and deed of trust.

Reduction of the 15-year recapture period currently provided for in section 2032A is excessive and is not needed to deter speculation or assure retention in the family of the farm or ranch land and continuation of the family operation. Moreover, a 15-year recapture period may unfairly tie the hands of the surviving family in disposing of the land for legitimate business reasons.

Under S. 1984, the 15-year recapture period is reduced to a 10-year recapture period. This amendment to section 2032A will help mitigate the potential problems of current law and the substituted 10-year period is fully adequate to assure continued use of the property for farming purposes and to deter speculation. Moreover, NCA would suggest that consideration be given to reducing the recapture period even further to a lesser period, such as 5 or 8 years.

Special rules for tax-free exchanges. Under the existing provisions of section 2032A, the imposition of an additional estate tax can be avoided on a tax-free exchange of farm or ranch land involving qualified property only if the qualified property is exchanged with another family member.

However, economic factors and climactic conditions frequently make tax-free exchanges of farm and ranch land advisable, and there is no reason to restrict such transactions to exchanges between family members.

This issue is addressed by S. 1984 by providing that no additional estate tax would be imposed by an exchange of property of the type which would qualify for tax-free treatment under section 1031 of the Internal Revenue Code provided the property received in the exchange is used for the qualified use.

NCA endorses such provisions of S. 1984.

NCA would suggest that the section 2032A be amended to permit property received in a tax-free exchange—Mr. Chairman, would it be satisfactory for me to go slightly overtime?

Senator BYRD. Yes. Don't go too far overtime, please.

Mr. POWELL. NCA suggests that section 2032A be amended to permit property received in a tax-free exchange prior to date of death to qualify under section 2032A as long as the property received in the exchange and the property transferred in the exchange would, together, meet the predeath tests of ownership and material participation or some substituted active involvement test as previously outlined. A similar rule should also be applied to qualified replacement property acquired by a decedent within 5 years of date of death with proceeds from an involuntary conversion of qualified real property.

Mr. Chairman, in the balance of the statement——

Senator BYRD. Your complete statement will be published in the record.

Let me ask you this and then I'll yield to Senator Nelson. As I understand it, all of you favor S. 1984 and S. 1825 and S. 2220, but Mr. Wolf recommends that S. 2220 go somewhat further than the bill itself. Is that correct?

Mr. WOLF. Yes, that's correct.

Senator BYRD. Senator Nelson, may I ask you, these two bills, they represent the substance of the recommendations, some of the recommendations of the White House Conference on Small Business?

Senator NELSON. Yes, S. 2220 was a specific recommendation in the White House Conference. We had already put in another bill increasing the estate tax exemption simply to compensate for the inflation that has occurred since the estate tax exemption was raised from $60,000 to $175,000. But S. 2220 did come from the White House Conference.

I think the testimony has been very useful and valuable. I believe Federal taxes on interspousal transfers should be eliminated so that a surviving spouse would not have to pay a tax upon the estate. Under the current law, you very frequently see an estate that is taxed twice in a 7-year period. And that, in my judgment, is unnecessarily burdensome upon the estate and upon the concept of maintaining the family business.

So I'm very interested in the suggestions made by today's witnesses. I shall review the testimony and I may be prepared to offer a substitute amendment to S. 2220 now that we've had the benefit of an analysis from the witnesses today.

Mr. JONES. Mr. Chairman, might I interject here, and Mr. Nelson, that with respect to S. 2220, we do feel that there needs to be some study of the interaction of this bill with section 2032A, the special use valuation provision, and also we see that you would run into the same problem with the bill, as it's now written, in material participation as we're running into with the current law.

So we would suggest that those two matters be considered with respect to S. 2220. We support the concept but we do see those two red flags.

Senator BYRD. May I say, Senator Nelson, the four panelists earlier suggested that it might be worthwhile to consider, your staff and the committee staff taking these three bills and trying to work them into one bill, since they deal with basically the same subject and seem to have the endorsement of most of the witnesses.

I regret the Treasury is not here. I think it's important to get the Treasury's position on all these.

Senator Nelson has been appointed chairman of the Ad Hoc Small Business Task Force. I'm glad to be a member of his ad hoc task force. Senator Nelson thought that the Congress should give early consideration to that recommendation to the White House Conference on Small Business, so we arranged promptly to hold these hearings. I do think it's important that Treasury present its view. Representatives of Treasury will be most welcome at the next two meetings that we will have and I hope that they will be here. I will contact them again, Senator Nelson, for the next two hearings that we will hold.

Senator NELSON. I want to thank you, Mr.Chairman, for the promptness with which you responded by scheduling these hearings. I think this is the first set of hearings of any of the committees on proposals of the White House Conference.

Senator BYRD. Thank you, gentlemen. You've been very helpful.

[The prepared statements of the preceding panel follow:]

STATEMENT OF STEVAN A. WOLF, NATIONAL FAMILY BUSINESS COUNCIL

Good morning. My name is Stevan Wolf. I am the General Manager of our Family Business, the Letty Lane Co., Inc., of Westville, New Jersey and am here today on behalf of the National Family Business Council (N.F.B.C.). I am a past President and the current Government Affairs Chairman of the N.F.B.C., Trustee of the National Small Business Association, and the N.F.B.C., representative on the Small Business Legislative Council. My purpose today is to address Senate bill S-2220.

Mark Burrall, past president and current member of our Board of Directors, from Green Bay, Wisconsin, has asked me to pass on his personal congratulations and thanks to Senator Gaylord Nelson on behalf of all of our Wisconsin members, for his sponsorship of this most significant and timely legislation.

The entire membership of the N.F.B.C. also wishes to compliment and thank Senator Nelson, as well as its other cosponsors, Senators Baucus, Heinz and Stewart for introducing S-2220. Also, we appreciate the foresight of the Senate Finance Subcommittee, and in particular Senator Byrd, who understands the problems of Family Businesses, for scheduling this hearing at this time.

The National Family Business Council is a nonprofit membership association that was chartered to promote the interests of Family Business in the United States, with all members of the Council active family business people.

Our purposes: To insure the survival of individuals working in their family business and the survival of Family Business within our free enterprise system; to encourage the perpetuation of Family Business within the family structure through the passing of ownership and management from generation to generation; to offer continuing education, a library of information, and other services to the Family Business community to enable them to more effectively compete in their marketplace; to create awareness of and encourage the use of professional management skills in the operation of family firms; to help maintain a strong private sector in our economy; and to act as the voice for Family Business at Federal, State and local levels of government.

Unlike trade associations, we do not represent one industry grouping, nor are we primarily a lobby or special interest group; rather, our member base is widely divergent, drawing representatives from a variety of manufacturing, wholesaling and retailing firms, as well as the professions.

Our members are comprised of a network of local chapters and members-at-large all united by the common bond of working to strengthen and maintain their family enterprise.

In addition to legislative initiatives, we sponsor seminars and workshops aimed at providing a forum for the exchange of ideas and information relating to problems common to the family business community. With over ten million family firms in America, we are the only organization devoted specifically to the betterment of family enterprise.

Of the hundreds of issues confronting the small business community, delegates at the recently concluded White House Conference on Small Business elected revision of estate tax laws to encourage continuity of family ownership as the fourth most important priority. It is interesting to note that only twenty votes separated this issue from second place. Clearly, this strong display of feeling is a mandate for change.

Existing estate tax laws frequently cause heirs to liquidate the family business or to sell the business to a larger, usually public, concern. By providing an incentive to keep the enterprise under family control, that business will continue to pay its share of taxes. Employees will be retained, thus eliminating their need to resort to federal unemployment benefits. Keeping in mind that it is small, privately held firms which account for the majority of employment opportunities, as well as technological innovations, we could therefore expect to derive greater social as well as economic benefits.

Senator Nelson and his staff demonstrated his commitment and sensitivity to small business by introducing S-2220 on January 24, 1980, just seven days after the closing of the White House Conference. While we applaud the principles and overall approach of S-2220 as drafted, we feel there are clarifications and additions that should be made in order for the bill to meet its objectives.

SECTION 2040A: FAMILY BUSINESS INTERESTS

Under section (b) Limitations, (1) 50 Percent Minimum Exclusion, we feel that the 50 percent exclusion is acceptable without reference being made to section 2040(c) of the Internal Revenue Code. It should be clearly stated that the qualified recipient, the child of the decedent, and the spouse, are each entitled to a separate application of this section with only the spouse required to include section 2040(c) in the aggregate value of his or her reduction of the decedent's gross estate.

Under section (b) Limitations, (2) Aggregate Reduction, we strongly feel that the limit of $500,000 is inadequate as an inducement to perpetuate a Family Business. The National Family Business Council, based upon a poll of its members, believes that ideally there should be no imposition of estate taxes on business assets transferred to qualifying recipients. In its entirety, estate tax income comprises between 1 percent and 2 percent of total federal revenues. That portion which can be ascribed to taxes collected from the value of business assets of family business owners brings total monies under examination to far under 1 percent. If our Treasury Department claims that a revenue loss of $500,000,000 would result from this legislation, that represents only .086 percent of our total Federal budget. This short term revenue deficit will be more than compensated for by increased tax funds collected over time as family firms remain healthy and viable. Also, the government would save on the transfer payments for those workers who have to relocate or change jobs due to the closing and/or sale of the Family Business. Monies normally spent on unemployment, welfare, and training would be saved.

In addition, the gains made in estate tax treatment of small, closely-held businesses as a result of the Tax Reform Act of 1976, have been wiped out by high inflation rates in the past three years. With the increasing trend toward merger and economic concentration in the United States, major changes in the estate and gift tax treatment are needed to insure the continued independence and competitiveness of the small, private sector of our economy.

We fully and regretfully acknowledge that current political realities make immediate acceptance of this proposition unlikely, and we therefore recommend instituting a ceiling of 50 percent of the value of the business or $1,000,000 as a first, but important step toward establishing a significant incentive to transfer a family business to a succeeding generation.

If sections (a) and (b) are going to remain unchanged in substance, the intent should be clearly spelled out that the 50 percent limitation applies to 50 percent of the value of only included assets in the decedent's gross estate. It is clearly not intended that the 50 percent be applied to non-included assets.

For example, XYZ Corporation is worth $2,000,000. X, a 100 percent owner four year prior to his death transfers 50 percent of his stock to Y, his son. Upon X's death, he bequeathed his remaining stock to Y, who had been a material participant in XYZ Corporation for 10 years. The deduction is limited to $500,000 (50 percent of the included $1,000,000).

Section (c), Definitions and Special Rules, is capable of being interpreted by the taxpayer in the broadest possible manner and by the government in just the opposite way. Terms such as "any interest", are not specifically defined. We would strongly recommend adding "includable" so that it is again clear that the reduction only applies to any interest which is otherwise includable in the gross estate. A better reading of the section would therefore be ". . . any interest, otherwise includable in the gross estate. . ."

The term "trade or other business" is not defined and, as written, could apply to many more entities than merely closely held corporations and/or family partnerships. Without further clarification "trade or other business" could also apply to holding companies and/or holding operating companies if they fell into the broad category of "trades or other business." For example, assume the assets of XYZ Corporation are purchased by Q during the lifetime of Z, Y and Z for $2,000,000. X, Y and Z retire from their operating company and use the proceeds to continue XYZ Corporation as an investment company.

Later, X dies, leaving his interest in XYZ to Y and Z, his two sons, who were active in XYZ as an operating company. Assume X's interest in the Corporation was $1,000,000 and Y and Z were material participants for over 10 years. It would clearly be beneficial to X's estate to qualify for the 50 percent reduction. Under the Section, as written, it is not clear whether XYZ holding company qualifies.

Further, it is not clear if the time Y and Z spent in the old XYZ operating company counts as material participation in the new XYZ holding company. If the purpose of the law is family business continuity, the format of the business, old or new, should not matter. In order to give the family business flexibility, the statute should include the holding company and change of business situations. What occurs when Q buys the assets of XYZ is not the end of one business, but really the continuation of XYZ old in a different format and the start of XYZ new as a different operation. The end result is two businesses, and that should be encouraged.

Section (c)(1) refers to Section 2040A property as ". . . any interest in any real or tangible personal property . . ." (emphasis added). The term tangible personal property, by definition, clearly excludes goodwill, and might exclude the value of patents, copyright, exclusive contracts, exclusive territories, etc. These are all valuable assets in establishing fair market value for estate tax purposes under Section 2031 of the Code. Under the proposed law, these items could not be taken into account for Section 2040A reduction purposes. However, they still would be considered by the Internal Revenue Service for inclusion purposes.

An example of what could occur follows. XYZ is valued under Schedule B of the 706 for federal estate tax purposes at $2,000,000, of which $400,000 is goodwill. The 2040A deduction, assuming the property passes to a qualifying heir, would be limited to $600,000 instead of $1,000,000. Depending on the tax bracket involved, up to $140,000 of additional federal estate tax might be paid.

If an asset's goodwill is valuable for inclusion purposes then it should be valuable for 2040A exclusion purposes. It is very clear that the value will not be lowered under Section 2031 simply because Section 2040A limits valuable assets to tangibles. Therefore, both tangibles and intangibles must be considered under 2040A. The key is not what passes, but what is included in gross estate!

Finally, Section (c)(1) limits the deduction only to cases where the farm or other business interest passes to a surviving spouse or any child. This is extremely limited in nature and does not really encompass what the "National Family Business Preservation Act" has as its real purpose.

The idea is to allow a deduction for two paramount reasons—prior participation in a farm or trade or other business and continued future paticipation in the same farm or trade or business. Why should the deduction be limited to a surviving spouse or children?

The proposed Section could easily be amended to include those covered under the attribution Section of the Code (318). This would add parents, spouses of children, and grandchildren to surviving spouses and children. This would allow an individual owner to receive the deduction if he passed his stock to a participating son-in-law or a participating grandchild. This would allow for greater flexibility and much more realistically cover the usual everyday situations where some members, but not all, of an individual's family are in the business.

Section (c)(2) defines Section 2040A value as the value of the interest, without regard to this section, reduced by 5 percent of each taxable year a qualifying heir materially participated in the farm or business, specifically in question. If the qualified heir materially participated in the taxable year of death, it's presumed that he has participated in the five succeeding taxable years at 5 percent per year. We feel that this rule should be simplified to accomplish its objective—perpetuation of the Family Business by its Family members. To do this, we strongly recommended that all 2040A interests be given the full 50 percent reduction as long as the qualified recipient has materially participated during the taxable year in which the date of death of the decedent occurs.

Another area to be considered is the fact that in this legislation there is no indication that the heir receives a stepped up basis on future capital gains. This means that if a sale of some or all of the 2040A interest is made following the five year recapture date, there would be a larger capital gain on the value of the 2040A interest. This will mitigate the loss in revenue due to the passing of the 2040A property on to a qualified recipient of the decedent.

If this is acceptable, then instead of a 50 percent plus $1,000,000 limit, all limitations could be removed from the transfer of the 2040A, thus allowing a farm or business interest to pass estate tax free and, quite conceivably, could be the first in a series of steps which could do away with the estate tax entirely. Since there would be not stepped up bases for the heir, the capital gains tax on the 2040A interest would recapture the lost revenues at the time of death of the decedent.

Under Section (d), Tax Treatment of Dispositions and Failure to Use, the estate tax originally saved is imposed if the interest in the farm or business is disposed of within five years of the date of death, or if the heir ceases to use Section 2040A property as a farm or trade or other business, with the owner being allowed to sell the 2040A interest to persons included in Section 318 of the Internal Revenue Code. It must be stated that full recapture of the federal estate tax is required and that the qualified recipient is responsible for the payment of this tax.

The proposed statute does not indicate who is liable for the payment of the tax. Therefore, under existing law, the estate would be primarily liable and thus would have to remain open for a full five years or until the qualified heir did something to trigger imposition of the tax. This may not be the desired result.

In the initial instance, it is the estate and effectively other residuary beneficiaries to whom the 2040A deduction accrues. However, after the fact, the ball is in the hands of the qualifying heir. If he continues the business for five years, the deduction stands; if he does not, the property reverts back to its original value and the estate is liable for any taxes owed. A better wording of the law should make the qualifying heir liable for the tax his action causes. An example, perhaps, best shows the potential problem.

X dies, leaving his entire interest in XYZ, Inc. to Y, his son. He leaves the residue of his estate to Z, a non-relative. Taxes are to be paid out of residue. XYZ, Inc. at death is worth $1,000,000 and X has a residue after payment of expenses and debts, but before taxes, of $1,000,000. Since XYZ passed to a qualifying heir only one-half, or $500,000, is included in the gross estate (assuming all other requirements are met). Therefore, instead of paying a gross federal tax (before any credits) of $780,800 only $555,800 is due—a saving of some $225,000. Since taxes come out of the residuary share, Z would receive $444,200 before any credits or other estate taxes.

If within five years Y sells the business, the estate (effectively Z) would be liable for an additional $225,000—probably plus interest. There is an obvious solution, i.e., allow X to provide for the payment of taxes in his will. In the cited example, that would work; but if Y were X's spouse, the best saving would undoubtedly be to allow the maximum necessary marital deduction. In such a case, it might not be prudent or possible to provide for the payment of additional taxes by the recipient of the business or farm entity. In that situtation, it would be better to have a statute which made the recipient primarily liable for the taxes upon the occurrence of a 2040A(d) triggering event.

Other possible problem areas in 2040A(d) regarding disposition or cessation of use for 2040A purposes involve the fact that 2040A(d) is so all encompassing in its use of terms like ". . . disposition of any interest . . ." and ". . . if the surviving spouse or any child . . . ceases to use. . . ."

A potential difficulty exists with the "ceases to use" phrase if through no fault of their own, a surviving qualifying heir becomes incapable of performing within the five year period. This stoppage could be occasioned either through disability or death.

If the original qualifying heir passes his interest to another qualifying heir at death, would the original exclusion be continued? Would a second exclusion be in order? Is there a further proportional limitation? None of these potentialities are adequately covered by the statute as written. Death or disability of a qualifying heir should not trigger imposition of the estate tax saved if a new qualifying heir can replace the disabled one. Again, this is why it is very important, at the very least, to extend those covered under the new Section to those spelled out under Section 318.

Also, with regard to the clause ". . . disposition of any interest . . ." (by the spouse or any child), depending on state law, a 303 redemption to pay taxes and expenses might be a disposition by the heirs and not the decedent. As noted, this is contingent on state law and the provisions of the decedent's will. But such necessary redemptions could be specifically exempted from triggering status in the original legislation. The statute, as written, would seem to preclude any corporate reorganization within five years, and it would clearly prevent any mergers or takeovers within the same five year time frame. All of these prohibitions would seem to inhibit business continuity rather than preserving or aiding it.

It is very clear that the above cited phrases in 2040A(d) tie the hands of the estate, the business, and the continuing qualifying owners for a full five years. When you couple this with the fact that an inadvertent or controllable/accidental cessation of business, for the briefest of times, triggers payment of a potentially inordinate amount of tax and interest, it is very important that this Section be given the closest scrutiny. If possible, it should be deleted; if not, at least watered down. Items like the disability or death of the subsequent qualifying heir should not trigger the tax. Nor should accidental destruction of the property (as through an act of God). Under the current proposed legislation all of these occurrences would cause the tax to be assessed.

With the unification of federal estate and gift taxes, we believe that any bill which attempts to reduce the value of an interest in property for purposes of computation of the federal estate tax must also contain a companion provision to effect a reduction in the federal gift tax as well. In the absence of a companion gift tax provision, there is a built-in inducement to hold property until death and to discriminate against inter vivos transfers. Frequently, the owner of a family-owned business will want to make an inter vivos transfer of an interest in that business to a family member in order to induce or enhance the interest of that family member's participation in the business. S. 2220 will have an adverse effect in this regard.

By instituting these changes and making S. 2220 a simple, but complete package by which the management and ownership of our Nation's Family Businesses can be passed from generation to generation, you will be eliminating a vast bureaucratic nightmare that represents less than 1/1000th of the total Federal Budget. Also, you will have effectively separated the business interest from one's personal property and allowed the smooth transition to the next generation of owner/manager.

If these changes are not enacted, you will have to contend with other areas of the federal estate tax laws that are cumbersome, confusing, and very damaging to the small, private sector. Included in these areas are the need to maintain a fair and reasonable interest rate on the estate tax payments in Section 6601 of the Internal Revenue Code, the approach used by the Internal Revenue Service in valuing a farm or business, the accumulated earnings penalty tax, the qualifications test for Section 303 stock redemptions to pay death taxes, and many other areas that can be read in the fine print of the Internal Revenue Code.

The original intent of the Federal Estate tax was to limit the amassing of wealth by individuals. This is a principle with which we do not take issue. We are by no means opposed to paying our fair share of taxes. In fact, the record will show that privately held firms have always paid a higher percentage of their profits in taxes than have the giant corporations and conglomerates. During the past sixty years, however, changes in our society and economy have resulted in altering the effect of this legislation, causing hardship of the transfer of the Family Business within one's family.

Recent changes were made in the Estate Tax Laws in 1976 to aid the transfer of ownership of the Family Business. These changes will not be enough to maintain a strong private sector. The continuing spiral of inflation, changes to our economy brought on by world pressures, and the ever-present energy crisis will take its toll on discouraging individual entrepreneurs.

Even though there are numerous ways to plan effectively for the transfer of ownership, the process of estate planning takes valuable time and money away from constructive uses, thus stifling productivity, ingenuity and technological improvements. Financing the transfer of the ownership within the family then becomes a critical challange. Inheritance taxes on business assets, multiplied by the effect of inflation, are so high as to drain funds from working capital, and this, coupled with the enormously complex task of estate valuation, forces the entrepreneur to think of retention before growth.

It is difficult enough to plan for the transition of management control at the time of loss of the founder or entrepreneur. Generally, when the owner of a closely held business dies, his working heirs have their hands full keeping the business afloat. This is a crucial period in which the firm is highly vulnerable. In the face of this fact, it is also their responsibility to battle the government over the current market value of their business. The government becomes an antagonist, trying to extract the maximum payment of inheritance taxes, rather than helping the business to remain a solvent, contributing asset to the economy. This entire process must be made easier to understand and manage.

It is not our intent to help individuals amass wealth, but we are interested in the perpetuation of our Family Businesses from generation to generation. We feel keenly about the role that we play in the maintenace of a strong private sector in our economy. These recommended changes will encourage the emergence of more entrepreneurs into the marketplace. Also, by creating an easier method by which to transfer ownership, there will be future generations to maintain these family businesses.

Our country will benefit from these changes. By supporting growth in the private sector, there will be an expansion of the size of the tax-paying universe at all levels of government. If the estate tax laws are not changed to meet the current and future needs of our nation's family businesses, there will be a reduction of this tax base and further burdens will be placed upon our economy.

Our challenge to you, our law makers, is to recognize the needs of the family business community as articulated not only by the National Family Business Council, but also by the delegates to the White House Conference on Small Business. Act now to preserve this vital source of entrepreneurial opportunity, employment, and technological development. Reverse the flow which finds the family business a fading anachronistic dream and help it to flourish once again. Keep the family business sector strong, and we will in turn do our part in strengthening the economy and social fabric of America.

THE DAVIS-DANN AGENCY,
Chicago, Ill., March 4, 1980.

Mr. ELLIOTT MALLON,
Chas. U. Victor Co. Inc., Chicago, Ill.

DEAR ELLIOTT: I reviewed proposed Bill S. 2220 introduced by Senator Gaylord Nelson which proposes that some relief from Estate Taxation be given decedent's estates whose spouse and/or children work in a family business. As an insurance practitioner, primarily dealing with estate planning for closely held business owners, I am acutely aware of the need for relief and thus strongly support this legislation. Indeed, I think that it might not go far enough in preserving this most important segment of our business community.

The Tax Reform Act of 1976 raised the level at which Estate Taxes will be incurred, but for those estates which exceed this level the taxes become more severe. Further, double digit inflation exacerbates the problem, and is really the most insidious aspect of the Estate Tax. A business may experience a substantial increase in value, largely attributable to inflation, yet have little if any real growth. However, this illusory inflationary growth will ultimately be subjected to a progressive Estate Tax. The dilemma to the estate owner should be apparent, as his ability and industriousness (helped by inflation) causes the business to prosper, it becomes more probable that the business will be sold or liquidated at death to generate the liquidity required to pay taxes.

Estate planners and insurance salesmen are not devoid of certain solutions, but a review of some of these devices will clarify why in many respects they are less than adequate and in some cases too expensive to implement (an impediment not hampering the planning for the very wealthy).

1. A co-owner of a closely held business usually is party to an agreement to purchase his interest at death. That is not the case in a family business where the interest is to be retained.

2. In certain instances, a portion of the estate tax can be paid in installments. This isn't a reduction in the tax but merely a deferral upon which interest is payable. In a sense such so-called relief often operates in practice as a burden on the survivors.

3. Freezing techniques on business valuations can be implemented, but is very sophisticated and expensive planning.

4. The closely held corporation can buy a portion of the decendent's stock to pay estate taxes. However, accumulating surplus to effectuate such a purchase can be subject to a penalty tax and the extra surplus or insurance acquired to fund the purchase, increases the value of the stock which further increases the tax.

5. Personal insurance is often a recommended solution to raise estate liquidity but it would be better if that coverage could all be allocated to the direct needs of dependents rather than to pay estate taxes.

6. Employee benefit programs can often provide cash to the estate, but they cannot be designed to only assist the business owner, and this costs for comparable benefits to other employees usually prevent these programs from being more than a partial solution.

The owner of a family business is usually shocked when he learns of the limited likelihood that his business, his pride and joy, can be preserved for his family. Many respond with apathy, particularly since estate and insurance planning may only offer partial solutions. In my opinion, Congressional action is justified to preserve the family business which has proven to be one of American's most productive and creative resources.

My best wishes for the success of S. 2220.

Very truly yours,

HEBERT J. DAVIS, C.L.U., J.D.

COGEN, SKLAR & CO.,
Bala Cynwyd, Pa., March 13, 1980.

Mr. STEVAN WOLF,
Letty Lane Co., Inc.,
Westville, N.J.

DEAR STEVE: Thank you for sending me proposed Senate Bill S. 2220 which provides for a change in the estate tax related to family businesses. As a certified public accountant in public practice for overy twenty years, I believe I am qualified to comment on this legislation.

My practice includes reviewing tax responsibilities with our clients. We calculate expected tax liabilities and discuss these results with the taxpayers. With regard to estate tax, we plan how the closely-held business should meet these tax responsibilities. Usually, the discussions result in the decision to purchase additional life insurance or to sell the business to improve liquidity.

Purchasing additional life insurance (when available) adds to the operating expenses of the business. This requires the business to increase the price of its product or to have less capital available for expansion. Either way, the business is not competitive with large companies which do not require this insurance.

I have seen numerous cases where the owners of a small business use the other alternative and sell their business either to prepare for or pay the large estate tax attributable to this business. In most cases, the purchaser was a larger company.

With inflation artificially increasing the values of even the smallest business, in my opinion, relief is badly needed to preserve the small, family-owned business in our society.

Sincerely,

L. MARTIN MILLER.

THE CENTER FOR FAMILY BUSINESS,
UNIVERSITY SERVICES INSTITUTE,
Cleveland, Ohio, March 14, 1980.

Mr. STEVAN A. WOLF,
Letty Lane Candy Co.
Westville, N.J.

DEAR STEVE: It's no surprise to me that people of influence in this country have suddenly "discovered" so-called small business. I imagine they feel a lot like the last skipper of the Titanic when he "discovered" a suddent interest in icebergs.

When it comes to privately owned businesses, most people seem to steam along in a complete fog, caused in great part by that insensitive diminutive "small business." It's true that these businesses seem to form a kind of shadow economy, but the shadow they cast is immense.

Just look around as you drive through any commercial or industrial area in any American City, and a little mental arithmetic will soon demonstrate what I mean by immense. Let me bore you with statistics for a minute.

Owner-managed businesses account for over 99% of the almost 14 million business enterprises in the country. They employ over 50% of the nonagricultural workers in the private sector and account for 43% of the Gross National Product. That's almost half of the business output of the entire economy.

Think about what these figures mean. The IRS counted 13.9 million business enterprises in 1974, 3.4 million of which were beyond the proprietorship stage. More than 2.3 million of these were corporations.

Of this total activity, so-called "big business," the few thousand corporations listed on the various stock exchanges and traded over the counter, represent a relatively microscopic .04% of all business, and only .3% of all corporations.

These facts are no great secret. So the question arises: why has the closely held business been so widely mistreated for so long? I don't believe size or influence is the key, so much as the negative connotations that go along with the word "small."

The family-owned business remains essentially unrecognized because it is widely looked down upon and—by some—despised. Somehow "small" has been taken to mean less good than "big."

Business owners suffer from a managerial inferiority complex that's neatly reinforced by that smug classification, "small" business.

Because their businesses absorb almost all of their energy, they don't take time to talk honestly and share experience with each other. Because they built their success on luck, guts, and raw talent rather than credentials, they don't seek or receive recognition from the establishment press.

Because of this sense of inferiority, they have little idea of the energy their independence and success tends to create in others.

In spite of their great numbers, business founders don't share a commonality of business interest. They tend, instead, to be isolated, insular and parochial.

These entrepreneurs struggle alone, mostly. And, mostly, they just don't make it. Thirty percent of them throw in the towel in the first year. Fifty percent are gone by the second. According to U.S. Treasury figures, only 25% of the businesses formed between 1956 and 1973 survive today.

The family-owned business tends to resemble the mule-hard working, productive, but sterile. It doesn't seem able to survive the first generation, the founder's generation, and I maintain that much of this problem is caused by a general misunderstanding of just how important these businesses, in aggregate, are to our economy.

Most of our largest corporations, for example, depend for their existence on a complex and interwoven network of independent suppliers and distributor/dealer/contractors.

So-called "small" businesses, therefore, have a collectively massive impact on sales and purchasing charts in the offices of the Fortune 500.

Also, because of the drive and talent of local entrepreneurs, because of their roots in the communities they serve, because they are building their own equity, family-owned businesses are a major source of large market shares and robust revenues for major corporations, public or private.

Yet these major corporations find themselves watching, sometimes helplessly, but too often uncaringly, as these distributors and suppliers wink out all over the country. They disappear either through liquidation, which leaves yawning gaps in marketing or supply networks, or through buyouts and mergers, which remove control from the manufacturer and leave the future in the hands of others.

What I suggest is that we stop thinking of the owner-managed business as small business and, instead, consider them to be the powerful economic units that they are. They don't need special treatment because they're little and helpless. They don't need government generosity or handouts. What they need is a free and open business climate in which they are recognized as important economic citizens.

I think if we look at our estate tax laws, we'll find that much of the estate looting the government does is based on a kind of moral conviction that business inheritance is somehow undemocratic. Somehow the growth of "small" businesses into significant businesses violates our sense of the way things should be. We somehow feel that these businesses should remember their place.

I suggest, instead, that it is we who should remember their place—their important and rightful place in the economy.

I wish you all the best in your good work.

Sincerely,

DONALD J. JONOVIC,
Director.

PREPARED STATEMENT OF JAMES L. POWELL, CHAIRMAN, TAXATION COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry—including cattle breeders, producers, and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle assoications and 15 affiliated national breed organizations.

SUMMARY

The National Cattlemen's Association ("NCA") strongly supports the concepts contained in S.1984, S.1825 and S.2220. These bills recognize the urgent need for amendments to the estate and gift tax laws as they apply to family-owned farms, ranches and other closely held businesses in order to correct certain gaps and oversights which occurred in the 1976 Tax Reform Act and the 1978 Revenue Act and to resolve issues which have developed as a result of Treasury's interpretation of certain provisions of these Acts. Senator Harry F. Byrd, Jr., Chairman of this Subcommittee, recently observed the necessity for such amendments by stating that "the estate tax is often levied at the precise time that a family has lost the principal wage earner and is undergoing a great financial upheaval. The same holds true for the family business which cannot rapidly recover from the loss of key personnel. If these considerations are not taken into account in the judicious administration of the estate tax, havoc may be wrecked upon the family and small family-owned and operated businesses may be forced into liquidation".

NCA urges adoption of the provisions of S.1984 which would: (1) provide an unlimited marital deduction so there could be tax-free transfers of property between spouses, either during lifetime or at death, in both community law and common law states; (2) increase the gift tax annual exclusion from its current $3,000 to a minimum of $6,000 and not include in a donor's estate gifts made within 3 years of date of death which were within the annual exclusion or which represented "split gifts" between a husband and wife within their combined annual exclusions; and (3) amend the special use valuation of farm land section (Section 2032A of the Internal Revenue Code) to eliminate the $500,000 limitation provision, to reduce the recapture period from 15 years to 10 years or even less, to permit the use of crop shares in the rental valuation formula, to provide for tax-free exchanges of qualified farm land and to eliminate the election requirement for involuntary conversions of such farm land. S.1984 would also abolish the material participation requirement of Section 2032A and NCA feels that while the problems created by the material participation standard should be remedied, some form of active involvement or "participation" standard should be retained. Further, NCA would suggest S. 1984 be amended with respect to Section 2032A to delete the "comparability" issue, to permit pre-death tax-free exchanges and involuntary conversions of qualified farm lands and to add the amount of any recapture tax to the income tax basis of property subject to recapture. In addition, NCA urge the combination of the provisions concerning defferred payment of estate taxes (Sections 6166 and 6166A of the Internal Revenue Code) into one provision with more liberal qualification rules and the application of the 4 percent interest rate to the estate tax attributable to the entire value of a qualified interest in a farm, ranch or other closely held business.

NCA endorses S.1825 which would increase the unified credit for transfers made during lifetime or at death from $47,000 (effective in 1981) to $70,700. NCA also supports the concept contained in S. 2220 to reduce the estate tax valuation of real and tangible personal property used for farming or other closely held businesses, but feels that a study should be made as to the interplay between the provisions of S. 2220 and those found in Section 2032A and other sections to determine the

preferable method for reducing value so that needed relief can be provided to estates of farmers, ranchers and owners of other closely held businesses in the most effective manner.

STATEMENT

INTRODUCTION

The National Cattlemen's Association (NCA) and other agricultural and closely held business organizations worked for a number of years prior to 1976 to demonstrate the need to Congress for remedial relief from estate and gift taxation for family-owned farms, ranches and other closely held businesses. These efforts were, in part, productive and resulted in the enactment in the 1976 Tax Reform Act of a number of provisions which were directed to achieve this goal. Analysis of these provisions enacted in 1976 as well as some of those contained in the 1978 Revenue Act has revealed the need for further major amendments to the estate and gift tax laws in order to bridge gaps which were created in the 1976 and 1978 legislation and to correct for some oversights which occurred in this legislation and also to respond to problems which have been raised as a result of interpretations given to these various estate and gift tax provisions by proposed Treasury regulations.

In commenting upon this need for further modifications to the estate and gift tax laws, Senator Harry F. Byrd, Jr., Chairman of this Subcommittee, recently noted that although the estimated receipts in 1980 for estate and gift taxes are only 5 billion dollars, which is less than what will be collected from the excise taxes on alcohol and tobacco, the estate and gift taxes have a potentially devastating effect on the family and on family-owned businesses. "This," Senator Byrd stated, "is because the estate tax is often levied at the precise time that a family has lost the principal wage earner and is undergoing a great financial upheaval. The same holds true for the family business which can not rapidly recover from the loss of key personnel. If these considerations are not taken into account in the judicious administration of the estate tax, havoc may be wrecked upon the family and small family-owned and operated businesses may be forced into liquidation."

NCA SUPPORTS CONCEPTS EMBODIED IN S. 1984, S. 1825 AND S. 2220

NCA supports the concepts contained in S. 1984, S. 1825 and S. 2220. These bills would have the effect of helping preserve the family farm, ranch and other closely held business when there is a death in the family and estate tax is imposed. These bills would also correct some of the problems, oversights and gaps in the 1976 and 1978 legislation which was designed to provide remedial estate tax relief to estates of farmers, ranchers and owners of other closely held businesses. Additionally, these bills would remedy some of the issues which have been created by proposed Treasury regulations interpreting certain aspects of the 1976 and 1978 legislation.

NCA commends Senator Wallop for his introduction of S. 1984 and feels enactment of this bill with certain modifications and additional provisions would be most beneficial to the whole agricultural community as well as to other closely held businesses. Further, NCA wishes to commend Senator Nelson for his introduction of S. 1825 and S. 2220 and also Senators Pell, Roth, Cranston, Packwood, Melcher, Thurmond and Jepsen for their sponsorship of S. 1825 and Senators Baucus, Heinz and Stewart for their sponsorship of S. 2220.

S. 1984

This bill contains a number of provisions which would be extremely helpful to family-owned farms, ranches and other closely held businesses. NCA feels that some modifications and additions to this bill would be of benefit and would help carry out its intended purpose.

(1) Unlimited marital estate and gift tax deduction

Under S. 1984, no estate or gift tax would be imposed upon certain transfers of property between spouses. This rule would obtain whether spouses lived in common law states or community property states. NCA strongly supports this unlimited marital deduction and feels that it would be most beneficial in all situations, but particularly with respect to transfers of farms and ranches between spouses either during lifetime or at death. It is the position of NCA that transfers between spouses are not an appropriate time to impose a tax since there are reasons to maintain the family unit and family business and to provide needed continuity.

Under existing law, the estate tax marital deduction is generally limited to the greater of $250,000 or 50 percent of the value of the adjusted grosss estate of the decedent. In addition, under present law the decedent's interest in community property does not qualify for the marital deduction. The provisions of S. 1984 would amend present law by providing an unlimited estate tax marital deduction for property passing from a decedent to a surviving spouse. The result of this beneficial amendment would be that estates could be planned so that there would be no estate tax on the estate of the first spouse to die. Additionally, an estate could be planned so as to take advantage of only a partial estate tax marital deduction, which in some instances might be desirable. While claiming 100 percent marital deduction in the estate of the first spouse to die could, in some instances, result in a higher tax when considering the tax on the death of the second spouse, in many cases an overall savings in both estates would occur because of the economic and related advantages of deferring the estate tax until the death of the second spouse. The result would be that the family would have the entire economic value of the farm, ranch or other closely held business during the lifetime of the surviving spouse without diminishment by estate taxes and would be able to continue such business without a severe disruption caused by the imposition of an estate tax.

An example can best illustrate this point. Assume an adjusted gross estate of $1,000,000. Under present law, in common law states, there would be a $500,000 marital deduction producing a taxable estate of $500,000 which would result in a tentative tax of approximately $155,800 less the unified credit of $47,000 (effective in 1981) which would produce a federal estate tax (not considering the state death tax credit) of $108,800. When the surviving spouse subsequently died, and assuming no increase or decrease in the $500,000 marital deduction amount which would be included in the surviving spouse's estate and assuming further that the non-marital share of the estate of the first spouse was placed in trust for the lifetime benefit of the surviving spouse, the estate tax in the surviving spouse's estate would also be $108,800. Thus, the combined estate tax in both estates would be $217,600.

If we next assume that there is an unlimited marital deduction which is taken advantage of in the first estate so that there is no tax in the first estate, the marital deduction would be approximately $825,000 and assuming again that this $825,000 was included in the estate of the surviving spouse with the remaining $175,000 not being included by virtue of having been placed in trust for the lifetime benefit of the surviving spouse, the estate tax in the second estate, after application of the $47,000 unified credit, would be approximately $230,550 (not considering the state death tax credit). Thus, while the total estate tax in both estates is about $13,000 more by using the unlimited marital deduction, the savings can be significant when considering that no tax was paid on the estate of the first spouse to die thereby avoiding payment of $108,800 in estate taxes in the first spouse's estate. If this sum of $108,800 were invested by the surviving spouse in an investment yielding 8 percent per annum, this investment would be about $17,400 in only 2 years. If the surviving spouse lived for 10 years, the savings generated would be approximately $87,000.

This example clearly evidences the significant economic benefit which can be achieved by deferral of estate taxes through the use of an unlimited marital deduction. In farm and ranch estates this will be very significant. Also, when it is considered that the farm land special use valuation provision would be available, the overall savings could be quite meaningful with the result that the farm and ranch operation could be continued by the spouse of the deceased farmer or rancher and then by the children without serious disruption caused by estate taxes. Moreover, the criticism that has been levied against the unlimited marital deduction of unfair treatment between common law and community property states would be obviated by S. 1984 which permits community property interests to qualify for this marital deduction.

Under present law, the gift tax marital deduction is $100,000 plus 50 percent for gifts to a spouse which exceed $200,000. One of the problems with the present law is that the estate tax marital deduction is reduced for taxable gifts made between spouses of less than $200,000 with the result that a greater tax may be paid in the estate of the first spouse to die. The provisions of S. 1984 would alter this be providing an unlimited marital deduction for gifts made between spouses. The logic of this provision is evident when considering the relationship which exists between husband and wife. Further, S. 1984 would remove the provision in present law which denies a marital deduction for community property interests which are transferred by gift between spouses by permitting a marital deduction for such transfers. Additionally, S. 1984 would eliminate much of the complexity which exists under present law in cases where the IRS is contending that the $100,000 marital deduction applies only once even though a person may be married a number of times and where the estate tax marital deduction is reduced by virtue of gifts of less than $200,000 made during lifetime between spouses.

The unlimited marital deduction would also eliminate many of the problems concerning contribution by a surviving spouse to jointly held property which resulted in enactment in the 1978 Revenue Act of Section 204(c) of the Internal Revenue Code as well as problems relating to potential gift tax liability where jointly held property used in a farming or ranching business is placed in co-tenancy or in a family partnership.

(2) Amendments to special farm use valuation provision

A number of amendments are made by S. 1984 to the farm use valuation provision (Section 2032A of the Internal Revenue Code) which was added by the 1976 Tax Reform Act. The stated congressional purpose for Section 2032A, which permits farm land and improvements to be valued for federal estate tax purposes based upon agricultural use, was "to encourage the continued use of property for farming . . ." by members of the deceased farmer's family. H.R. Rep. No. 94-1380, 94 Cong., 2d Sess., 22 (1976). S. 1984 would amend certain provisions of Section 2032A which would make this Section more responsive to this stated congressional purpose.

(a) *Elimination of $500,000 limitation.*—Under the present provisions of Section 2032A, special use valuation cannot reduce the fair market value of farm land by more than $500,000. This limitation is not explained in the Committee Reports and is contrary to the stated congressional purpose of providing much needed estate tax relief to family farms and ranches and encouraging the family ownership and operation of farms and ranches. By imposing a $500,000 limitation on the special use valuation provision, the benefits of the provision are significantly limited. With the growth in size of family owned agricultural operations, and the historic pattern of increasing farm land values, the $500,000 limitation severely and unnecessarily restricts the intended beneficial effect of Section 2032A.

U.S. Government figures reveal that in recent years farm land values have been increasing at a rapid rate. On a national basis the value of an average size farm has more than doubled since 1972 and further appreciation in farm land values is anticipated. This is demonstrated by the fact that in 1950 the average value of farm assets per farm was $23,400. In 1978 this average per farm value had increased to $250,000. Should this same trend continue, the average per farm value in 1983 will be over $500,000 and will exceed $2,400,000 in 2005.

In addition to this escalation in farm and ranch values, families are expanding the size of their farming and ranching operations to justify new expensive equipment which is needed in today's modern agricultural practice. This expansion helps lower the per-unit cost of production and thereby increases the revenues and ultimate profitability of the operation.

In light of these developments, the $500,000 limitation is counter-productive to the purpose of the farm use valuation provision which is to promote farming and ranching operations by family units and permit the transfer of farms and ranches to surviving family members without the imposition of disproportionate estate taxes that could result in a forced liquidation. As farm land values continue to grow, the $500,000 limitation will needlessly and unjustifiably circumscribe the benefits of the farm land valuation provision.

Sufficient restrictions are contained in Section 2032A to limit the benefits of the provision to estates of family-operated farms and ranches. Thus, the $500,000 limitation serves no useful purpose and is, in fact, detrimental to estates of deceased farmers and ranchers. For these reasons, the provision of S. 1984 to eliminate the $500,000 limitation is strongly supported by NCA.

(b) *Removal of material participation test.*—Under the present provisions of Section 2032A, the special farm land valuation will not be available unless there has been material participation in the farm operation by the decedent or a member of his family in 5 out of 8 years immediately preceding the decedent's death. A similar requirement is applied to the qualified heir who inherits the farm or ranch. The qualified heir or a member of his family must, during the 15 year period following the farmer's or rancher's death, materially participate in the operation of the farm or ranch for periods totaling 5 years in any 8 year period or else the recapture provisions will apply. "Whether or not there has been material participation by an individual . . . is to be determined in a manner similar to the manner in which material participation is determined for purposes of the tax on self-employment income with respect to the production of agricultural or horticultural commodities." H.R. Rep. No. 94-1380, 94 Cong., 2d Sess., 23 (1976).

A major problem has been created under present law by the pre-death material participation requirement. This is because farmers and ranchers who "materially participate" in the operation of all or a significant portion of their farm or ranch may be subject to self-employment tax on the earnings from the business and also might forfeit social security benefits to which they would otherwise be entitled. The result is that, in many cases, farmers and ranchers will be forced to decide whether they want the benefits of farm land valuation for their estates or whether they would rather receive full social security benefits and not be subject to self-employment tax on certain of their farm earnings during their lifetimes. Such a Hobson's choice is unfair and certainly was not the intent of Congress in passing the farm land valuation provision.

Problems are also raised by the requirement that there must be material participation by the qualified heir after the decedent's death. For example, an elderly surviving spouse may be physically unable to materially participate in the farm or ranch operation. A similar situation could occur with respect to minor children who inherit a farm or ranch. Additionally, in many situations a farm or ranch will not support more than one family unit at a time. As a consequence of this fact, and for a variety of other reasons, family members often have to farm elsewhere or leave the family farm or ranch during the life of the decedent and start other careers. On the decedent's death, it may be impossible, as a practical matter, for these family members immediately to return to the family farm and materially participate in its operation. Nevertheless, these family members may still desire to maintain the farm or ranch in the family and continue its operation through the use of agents or employees. Finally, during the period the estate is in probate, or if the land is placed in trust, it may be difficult for the heirs to satisfy the material participation requirements since the land will be effectively controlled by a fiduciary. Under these circumstances, it is unfair to discriminate against family members who find themselves in these situations.

In response to these problems, S. 1984 would eliminate the material participation requirement entirely. At the same time, S. 1984 would modify the threshold qualification test which under present law is that (a) 50 percent or more of the adjusted value of the gross estate consists of real or personal property which is being used for farming purposes and which passes to a qualified heir and (b) 25 percent of the adjusted value of the gross estate consists of real property which is used in farming and which passes to a qualified heir. Under S. 1984 the 50 percent and 25 percent requirements would be amended by eliminating the 25 percent requirement and by changing the 50 percent requirement to 65 percent with the result that the only threshold test of Section 2032A would be one where 65 percent or more of the adjusted value of the estate consisted of real and personal property used in farming and passed to a qualified heir.

NCA supports the concept of modifying the material participation test to make it workable in light of the problems previously cited. However, NCA feels there are sound and compelling reasons for retaining some form of active involvement or "participation" requirement by the decedent or by members of his family and by the heirs or members of their families. Without some form of active involvement or "participation" requirement, farm and ranch land may become a tax haven and cause potential bidding wars for available farm land between investors on one hand and farmers and ranchers on the other. NCA urges consideration be given to substituting some form of active involvement or "participation" requirement for both predeath and post-death material participation under existing law so that the ills which presently exist under the material participation standard of Section 2032A will be cured.

Additionally, NCA feels that the 65% rule of S. 1984 could pose problems to some farm and ranch estates in qualifying for Section 2032A treatment. This could happen, for instance, where an elderly farmer or rancher sells a portion of the farm or ranch to younger members of the family and takes back a note and deed of trust. On date of death, the note would be included in the deceased rancher's estate along with any ranch land he retained. In this instance, the note would not qualify under Section 2032A although the ranch land would and in many cases the ranch land and other ranch property may not equal 65% of the deceased rancher's gross estate. Also, many elderly farmers and ranchers are frequently advised by their tax and financial consultants to diversify their holdings to have some liquid assets to provide cash to pay certain expenses and taxes on date of death. Thus, NCA suggests that the 65% test under S. 1984 be re-examined to be sure that it will not adversely impact on estates of farmers, ranchers and owners of other closely held businesses.

(c) *Reduction of 15-year recapture period.*—Under the present provisions of Section 2032A, a recapture event occurs if within 15 years after the decedent's death, the qualified heir who inherits the farm land either caeases to use the land for farming or sells or disposes of it to a non-family member. The amount of the recapture is basically the tax benefit which accrued as a result of the special use valuation election under Section 2032A. The avowed congressional purpose for the recapture provision is to assure that the surviving family members use the farm land for agricultural purposes for a "reasonable period of time after the decedent's death." However, the 15-year recapture period currently provided for in Section 2032A is excessive and is not needed to deter speculation or assure retention in the family of the farm or ranch land and continuation of the family operation. Moreover, a 15-year recapture period may unfairly tie the hands of the surviving family in disposing of the land for legitimate business reasons. For example, during drought conditions such as have been recently experienced in certain parts of the country, it may be necessary to sell some land nd acquire other land in another region not affected by the drought. The 15-year recapture period could, under certain circumstances, also create title and loan problems by virtue of the lien which would be on the property throughout this period.

Under S. 1984, the 15-year recapture period is reduced to a 10-year recapture period. This amendment to Section 2032A will help mitigate the potential problems of current law and the substituted 10-year period is fully adequate to assure continued use of the property for farming purposes and to deter speculation. Moreover, NCA would suggest that consideration be given to reducing the recapture period even further to a lesser period, such as 5 to 8 years.

(d) Special rules for tax-free exchanges.—Under the existing provisions of Section 2032A, the imposition of an additional estate tax (i.e. recapture tax) can be avoided on a tax-free exchange of farm or ranch land involving qualified property only if the qualified property is exchanged with another family member. If the exchange is effected with a non-family member, the additional estate tax cannot be avoided even though farm or ranch land is received in exchange. However, economic factors and climactic conditions fredquently make tax-free exchanges of farm and ranch land advisable, and there is no reason to restrict such transactions to exchanges between family members.

This issue is addressed by S. 1984 by providing that no additional estate tax would be imposed by an exchange of property of the type which would qualify for tax-free treatment under Section 1031 of the Internal Revenue Code provided the property received in the exchange is used for the qualified use. Property acquired through such a tax-free exchange would continue to be treated as qualified real property. A disposition would be deemed to occur, however, to the extent that the qualified real property is exchanged for money, personal property or real property which will not be used for the qualified use.

NCA endorses this provision of S. 1984. In addition, NCA would request that consideration be given to amending Section 2032A to provide for a pre-death tax-free exchange of farm and ranch land as qualifying under Section 2032A even though the property received in the exchange and which is used for farming or other business purposes has not been held for 5 years prior to the decedent's death. There was speculation that IRS and Treasury might interpret Section 2032A to permit the tacking of holding and material participation periods where farm land had been involved in a tax-free exchange within five years prior to a decedent's death. These expectations were proven wrong by a recent pronouncement by IRS that it required the same property to be subject to the ownership and material participation requirements in order to qualify for Section 2032A treatment and that property received in a tax-free exchange prior to date of death would not qualify unless this five year rule was satisfied with respect to the property received in the exchange. NCA feels that this is an unfortunate interpretation of Section 2032A and would suggest that Section 2032A be amended to permit property received in a tax-free exchange prior to date of death to qualify under Section 2032A as long as the property received in the exchange and the property transferred in the exchange would, together, meet the pre-death tests of ownership and material participation or some substituted active involvement test as previously outlined. A similar rule should also be applied to qualified replacement property acquired by a decedent within five years of date of death with proceeds from an involuntary conversion of qualified real property.

(e) Election in voluntary conversions repealed.—Under the present provisions of Section 2032A, qualified heirs who receive farm or ranch land which has been specially valued and which is subsequently involuntarily converted, can avoid the recapture tax by reinvesting the condemnation proceeds in other qualified farm or ranch land. However, present law requires an election be made by the qualified heirs in order to avoid the recapture tax. It would seem appropriate to delete this requirement since an election will be made under the involuntary conversion provisions of the Internal Revenue Code and no additional election under Section 2032A appears appropriate or necessary. This problem is remedied by S. 1984 which eliminates the election requirement. NCA supports this provision.

(f) Use of crop share rentals in rental valuation formula.—Two methods for determining the agricultural value of farm and ranch land are specified under Section 2032A. One method uses a five factor test and the second stipulates that the value of farm and ranch real property which qualifies for the special use valuation

is determined by dividing "the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land by the average annual effective interest rate for all new Federal Land Bank loans." Each average annual computation is made on the basis of the five most recent calendar years ending before the farmer's or rancher's death. The stated congressional reasons for providing such mathematical formula were: (i) to reduce objectivity and controversy; (ii) to eliminate values which might be attributable to the potential for conversion to non-agricultural use; and (iii) to abolish "as a valuation factor any amount by which land is bid up by speculators in situations where non-agricultural use is not a factor in inflated farm land values." H.R. Rep. No. 94-1380, 94 Cong., 2d Sess., 24-25 (1976).

Proposed Treasury regulations issued in July, 1978 specified that crop shares could be coverted into cash equivalents for purposes of the rental valuation formula under Section 2032A. However, in September of 1979, new proposed Treasury regulations were issued which reversed this position and denied the use of crop share rentals in the rental valuation formula. The result of the new proposed Treasury regulations is to deny estates of farmers and ranchers the right to elect to value farm and ranch and land using the rental valuation formula when the only comparable land in the locality is subject in whole or in part to crop share rental arrangements. Since a large portion of the nation's leased farm land is subject to crop sharing or similar non-cash rental arrangements, the effect of this change in Treasury's interpretation of Section 2032A will be to prevent the use of the rental valuation formula to numerous estates of farmers and ranchers who live in areas where cash rentals are not used.

NCA presented testimony on this subject on March 4, 1980 to this Subcommittee relative to S. 1869 and S. 2201. It is the position of NCA that crop shares should be available for use in valuing qualified farm and ranch land under the rental valuation formula of Section 2032A. Moreover, permitting crop shares to be used in the rental valuation formula is in keeping with and fosters the original intent of Congress.

Contained in S. 1984 is a provision which would permit the use of crop shares under the rental valuation formula of Section 2032A. NCA supports this provision of S. 1984, but would urge that this provision be broadened to eliminate the "comparability" issue which has caused numerous problems during the last few years and can be expected to create even more problems in the future unless corrected.[1]

(g) Other proposed amendments to section 2032A which should be included in S. 1984.—Currently, when a recapture event occurs under Section 2032A, the amount of the recapture tax is not added to the basis of the farm or ranch land for income tax purposes. Under equitable tax principles, it would seem appropriate that the amount of the recapture tax be added to the income tax basis of the property at the time a recapture event occurs. Senator Durenberger has introduced S. 2266 which would accomplish this result and would apply to farm land inherited after 1976. NCA supports this concept and would urge its inclusion in S. 1984.

In the 1976 Tax Reform Act, it is clear that Congress intended the provisions of Section 2032A to apply to farm land which passes in trust. Further, Section 2032A to apply to farm land which passes in trust. Further, Section 2032A states that the Secretary of Treasury shall prescribe regulations setting forth how Section 2032A will apply in the case of an interest in a partnership, corporation or trust where the decedent had an interest in a closely held business within the meaning of Section 6166(b)(1) of the Internal Revenue Code. Concern has been expressed by some governmental officials that it will be difficult to draft rulings and regulations concerning the application of Section 2032A based upon such an abbreviated provision. NCA offers its assistance to work with committee staff members and governmental officials with regard to appropriate legislative language which may be necessary to give adequate direction in the drafting of rulings and regulations interpreting the application of Section 2032A to interests in partnerships, trusts and corporations which hold farm or ranch land.

Further, NCA is desirous of working with government officials and committee staff personnel with respect to resolving any other problems in administration and interpretation of and compliance with the provisions of Section 2032A so that the purposes of Section 2032A will be furthered and the benefits intended by Congress will be conferred upon the estates of farmers, ranchers and owners of other closely held businesses.

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[1] See attached Exhibit A which is a Bill that addresses both the crop share and comparability issues.

(3) Increase in annual gift tax exclusion

Two significant and needed changes in the Internal Revenue Code would be made by S. 1984 with respect to gifts subject to the annual gift tax exclusion. The first would increase the per donee annual exclusion from the present $3,000 amount to $6,000. The second would provide that to the extent gifts are not subject to gift tax by virtue of the exclusion, they would not be subject to inclusion in the estate of a decedent where such gifts were made within 3 years of the donor's date of death.

Under present law, a donor can exclude from the donor's taxable gifts up to $3,000 given in any year to one donee. S. 1984 would increase this to $6,000. The $3,000 annual exclusion has been in the law since the 1940's and NCA feels that a substantial increase in the annual exclusion is long overdue. Based upon cumulative inflation since 1940, the $3,000 annual exclusion should be over $16,000. As a first step in modifying the current annual exclusion of $3,000, NCA endorses increasing it to $6,000, but would support an even larger amount based upon inflation which has occurred.

Under S. 1984, gifts made within 3 years of a donor's date of death would receive special treatment where such gifts did not exceed the combined annual exclusions of husband and wife and when such gifts were split-gifts by husband and wife. Present law provides that gifts in any one year which exceed $3,000 are included in the estate of the donor at date of death values, if the donor dies within 3 years after making the gift. Under S. 1984, this "pull back" provision would not apply to gifts made within the amount of the annual exclusion. Additionally, where a gift to a donee is split by husband and wife, the 3 year "pull back" rule would not result in inclusion in their estates under S. 1984, unless the amount of the total gift exceeded the annual exclusions of both husband and wife. For example, if a husband were to gift $5,000 to a child which was consented to by his wife and then the husband should die within 3 years of making the gift, all of the gifted property would be included in the husband's estate at date of death values under current law, because it exceeded $3,000, even though his wife consented to making the gift and there was no gift tax due at the time the gift was made. This inequity in the law would be eliminated by S. 1984. NCA supports this provision which would be of significant benefit to farmers and ranchers. Because of rising values of farm and ranch land, annual gifts within the annual exclusion of $3,000 will not keep up with these escalating values and many times the farmer or rancher who enters into a gift program cannot progress very far if reliance is placed upon making gifts within the annual exclusion amount. Increasing the amount of the annual exclusion as well as permitting split gifts to escape inclusion for estate tax purposes would be extremely beneficial to farmers and ranchers and their estates and would encourage gift programs involving younger members of the family.

(4) Amendments to provisions concerning deferred payment of estate tax should be part of S. 1984.

Under present law, there are two provisions (Section 6166 and 6166A of the Internal Revenue Code) by which an executor can automatically extend the time for payment of estate taxes which are attributable to an interest in a farm, ranch or other closely held business. While these provisions are very similar, there are significant differences. The qualification requirements of these two provisions are not alike and the extended time for payment of the estate tax as well as events which accelerate payment of the unpaid tax vary. In addition, the interest rate payable on the unpaid amount of estate tax is not the same under these provisions. There seems to be no justifiable reason for the existence of these two different provisions with their differing requirements, especially since they are both designed to provide relief to estates of farmers, ranchers and owners of other closely held businesses. Also, the fact that these two provisions contain differing threshold requirements poses problems in the administration of estates of farmers, ranchers and owners of other closely held businesses.

NCA would urge that these two provisions be combined into a single provision and that the requirements for qualification be liberalized. NCA feels that a requirement that the value of the interest in the farm, ranch or other closely held business equal 35 percent of the value of the adjusted gross estate or 50 percent of the taxable estate would be proper. Additionally, NCA favors more liberalization in the definition of an "interest in a closely held business", in the ability to combine several related businesses and in the events which can cause acceleration in payment of unpaid installments.

Under current law, if at least 65 percent of the adjusted gross estate of a decedent consists of an interest in a farm, ranch or other closely-held business, and other requirements are met, then a special 4 percent interest rate is applied to the estate tax attributable to the first $1,000,000 in value of a farm, ranch or other closely held business property. With the present uptrend in values of farms and ranches and that anticipated in the future, it would seem appropriate to remove this $1,000,000 limitation and have the 4 percent interest rate apply to the tax on the entire value of the farm, ranch or other closely held business property, which meets the requirements of the new single estate tax deferral provision previously discussed. At present, to the extent the value of farms, ranches or other closely held businesses exceeds $1,000,000, the interest rate on the tax attributable to such value is now 12 percent. If the prime interest rate continues to increase, as it appears it will from all economic prognostications, this would mean this 12 percent interest rate would increase in coming years. To provide needed relief to estates of farmers, ranchers, and owners of other closely held businesses which qualify for deferred payment of estate taxes, the 4 percent interest rate should be made applicable to the tax on the entire value of a qualifying interest in a farm, ranch, or other closely held business. Senator Durenberger has addressed this problem by the introduction of S.2309 which would prevent the interest rate on the deferred payment of estate taxes attributable to the value of farms, ranches or other closely held businesses from increasing to 12 percent. However, NCA feels the preferred approach would be eliminate the $1,000,000 limitation so that the 4 percent interest rate would apply to the estate tax which is attributable to the entire valuation of a farm, ranch or other closely held business.

S. 1825—AMOUNT OF UNIFIED CREDIT INCREASED

Under the provision of S.1825 the amount of the unified credit would be increased from $47,000 (effective in 1981) to $70,700. The purpose of such increase is to reflect inflation which has occurred and also appreciation in value of most property, especially that of farms, ranches and other closely held businesses, since enactment of the $47,000 amount in 1976. The general effect of this amendment would be to permit the tax-free transfer during lifetime or at death of property which has a value of approximately $250,000. Under present law, beginning in 1981 the amount of property which can be transferred free of tax, either during lifetime or at death, is about $175,000. While a large number of farms and ranches presently exceed the sum of $175,000, it can be expected that many of them will even exceed $250,000. Further, from the figures previously quoted, the average value of farm and ranch property can be expected to increase in value even more in the future. Increasing the unified credit to $70,700 would help reduce the estate tax burden on farm and ranch estates and would have the salutary effect of fostering the transfer of farms and ranches to family members. To the extent the tax burden is lessened, this will mean there is a greater likelihood that family farms and ranches will be able to continue in operation without forced liquidations as a result of estate taxes, especially if some of the other provisions previously noted and supported by NCA are enacted into law.

S. 2220—family business protection act

Under S. 2220, a decedent's interest in real or tangible personal property which is devoted to farm uses or used for farming purposes or used in any other trade or business and which passes to a spouse or any child of the decedent can be reduced in value by 50 percent, up to a maximum of $500,000. There would be a 5 percent reduction for each taxable year in which the spouse or any child of the decedent materially participated in the farm or other business operation. Material participation would be determined in a manner similar to that for self-employment tax purposes. There would be a recapture of any tax savings accomplished by the use of the reduced valuation, if, within five years after the decedent's death, the surviving spouse or any child of the decedent disposed of an interest in the property or ceased to use the property as a farm or in another trade or business.

NCA supports the concept embodied in this bill for reducing estate taxes on farms, ranches and other closely held businesses, but feels further study should be undertaken in light of the provisions in Section 2032A concerning special valuation of farm, ranch and other closely held business property. Additionally, there would seem to be problems in imposing a material participation standard for the same reasons that currently exist under Section 2032A based upon Treasury's interpretation of "material participation".

CONCLUSION

NCA commends Senator Wallop for his introduction of S. 1984 and Senator Nelson for his introduction of S. 1825 and S. 2220 and applauds the support given these bills by Senators Pell, Roth, Cranston, Packwood, Melcher, Thurmond, Jepsen, Baucus, Heinz, and Stewart. NCA endorses the concepts contained in all these bills and would offer to work with the staff of the Committee in analyzing and making certain modifications and additions to these bills in order to provide equitable and needed remedial relief to family farms, ranches and other closely held businesses and to preserve and encourage their continued operation.

[Exhibit A]

A BILL

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

Paragraph (7) of Section 2032A(e) of the Internal Revenue Code of 1954 is amended to read as follows: "(7) Method of valuing farms—

(A) In General—Unless the executor elects to have the value of the farm for farming purposes determined under paragraph (8), the value of a farm for farming purposes shall be determined by dividing—(i) the excess of the amount of the average annual gross rental value of the qualified real property used for farming purposes over the amount of the average annual State and local real estate taxes for such qualified real property, by (ii) the average annual effective interest rate for all new Federal Land Bank loans.

For purposes of the preceding sentence, each average annual computation shall be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death.

(B) Application—The formula provided by subparagraph (A) shall be applicable regardless of whether the qualified real property or any portion thereof has in fact been rented or whether such qualified real property has been rented on a cash, crop shares, or other basis."

[Whereupon, at 1:25 p.m., the subcommittee recessed.]

VARIOUS TAX PROPOSALS

FRIDAY, MARCH 28, 1980

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT
MANAGEMENT GENERALLY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. presiding.

Present: Senator Byrd.

Senator BYRD. The hour of 9 having arrived, the committee will come to order.

In the American economy, small business is a significant and vital force; 90 percent of the new jobs in the last decade were created in the small business sector; 55 percent of all jobs today are in small businesses; 43 percent of our GNP, gross national product, arises from small business.

Small business provides the economic opportunity which is the cornerstone of our free enterprise system. The development of new ideas, new products and a personal stake in the success or failure of a business are important characteristics of small business and are the dynamic part of our economic system.

Today, small businesses have to face many problems. They lack internal capital necessary for greater growth. The risks inherent in small business enterprises discourages equity investment and encourages the merger of ongoing small businesses with larger corporations.

I think that is a particularly unhealthy possibility. Small businesses face mammoth Federal paperwork requirements and lack the professional resources to deal with these requirements. The measures before this subcommittee are designed to overcome these problems which are often embedded in our current tax system.

Some of the proposals deal with internal capital formation by changing the graduated corporate rate structure by reducing rates on lower income levels. Some revise the current depreciation laws, an important change, both from the point of view of internal capital generation and from the point of view of reducing paperwork requirements.

Other measures seek to encourage greater equity investment through tax credits for equity investment in small business and assisting security dealers in the marketing of small business issues.

Finally, some of the proposals deal with the heavy paperwork requirement on small businesss by making administrative changes to reduce this requirement.

In this regard, I should note that at a meeting with most of the Virginia home builders 2 days ago, the spokesman for the homebuilders said that 20 percent of the cost of building a home could be attributed to paperwork and Government regulations.

These proposals have arisen from recommendations by the White House Conference on Small Business. The subcommittee hearings are a result of the subcommittee's interest in these recommendations and in the work of the small business task force of the Senate, of which Senator Gaylord Nelson of Wisconsin is chairman.

The needs for small business with regard to taxation deserves careful attention. The continued vitality of the small business sector is necessary if our economy is to grow and our declining productivity is to be reduced.

I look forward to the comments of each of the witnesses on methods to revise the tax system, to encourage the development and maintenance of small business. I might say that the Treasury Department was invited to participate today, but felt for one reason or another that they could not do so. Maybe that indicates that Treasury will support these recommendations.

The first panel will have as its two members, Mr. Edward E. West, Jr., representing the Small Business Legislative Council. Mr. West is from the great city of Richmond, Va. And Mr. William Hambrecht, chairman, small business committee of the National Association of Securities Dealers, accompanied by Mr. Mason New, also of the city of Richmond, Va.

Welcome, gentleman. Will you come to the front desk?

Good morning. We are glad to have all of you with us today. Mr. West, do you wish to proceed first?

STATEMENT OF EDWARD E. WEST, JR., REPRESENTING THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. WEST. Mr. Chairman and members of the committee, good morning. My name is Edward E. West, Jr. I am president of West Engineering Co., Inc., designer and builder of precision small parts, assemblies and special machines.

With me is Mr. Bruce Hahn, Government Relations for National Tooling and Machining Association.

I am appearing today on behalf of the Small Business Legislative Council and the National Tooling and Machining Association. The Small Business Legislative Council is composed of 75 associations who with their affiliates speak for more than 4 million small businesses. The National Tooling and Machining Association represents 12,000 small businesses who manufacture tooling, dies, precision machined parts, molds and special machines.

We are grateful for this opportunity to discuss the capital formation problems of small business in America. The problems are great and they are aggravated even more by the current inflation and the present competition for working capital. In our industry, the problem is even greater because there is a severe shortage of skilled labor presently estimated at 14 percent in a February 28, 1980 industry survey.

The problem is that small businesses are typically labor intensive, highly competitive and low in profit. Despite this, they are the innovative entrepreneurs of our country. Results of studies have shown that small businesses produce 10 times the innovations for the R. & D. dollar compared to big business.

More importantly, strength of our economic system and one of its philosophical cornerstones is that there should be an opportunity for an ambitious hard-working person to enter business with some chance of success.

Today, it is much harder to enter business due to the cost of capital. Once in, it is harder to stay in and to grow.

In 1960, businesses with under $10 million in assets accounted for about 20 percent of the Nation's manufacturing assets while those with over $1 billion in assets held less than 30 percent.

In 1976, the former category declined to 10 percent while the latter increased to over 50 percent, and it is getting worse.

Many small business industries are critical to the country's health. Our industry makes it possible for virtually every other manufacturing industry to exist. Take for example the manufacture of a carburetor. To make that carburetor, molten aluminum is injected under pressure into the cavities of an extremely complex, precise mold.

Highly skilled technicians in our industry engineered and fabricated that mold. The molded carburetor body is then put on an automatic assembly line where additional machining is performed, holes drilled and parts attached. Our industry designed and built that assembly line which is, in fact, a special machine.

We designed the jigs and fixtures which drilled the holes at just the right angles to the exact depth. And while the carburetor was being built, body parts and bumpers were being formed in dies we produced, dashboards and plastic interior parts formed in our molds, and solid state radios produced with parts made in our molds and assembled with our special machines. The major industries which depend on our small businesses are virtually endless, including aerospace, defense electronics, appliances and most others.

There is a dangerous decline in productivity in this country and much of it is due to the fact that small business persons find it harder and harder to obtain capital to upgrade existing plant and equipment, much less to expand. In our industry, 78 percent of the companies have 30 employees or less.

Senator BYRD. Would you give that figure again?

Mr. WEST. In our industry, 78 percent of the companies have 30 employees or less.

Senator BYRD. Thank you.

Mr. WEST. A company with 30 employees might do $1.5 million in volume and make a net profit of 7 percent or $105,000. A small milling machine would have cost around $500 in the 1930's. Its modern counterpart, which is computer controlled and far more productive costs $60,000. Many modern machine tools cost over $200,000.

To buy that machine tool, I would have to pay for it out of profits on retained earnings. My profits are low, partly due to depreciation rates that are unrealistic in a modern industrialized country. When I go to a bank, one of the first questions asked is the size of the company. Banks are inherently very conservative in their lending policy. The major corporations get the most money at the best rates, the smaller companies get what is left over, if any, at a much higher rate.

The leftovers are getting smaller and established viable small businesses are increasingly being turned down flat. And when you add a couple of points to today's 19 percent prime rates, many probably could not afford it anyway.

There are not many other avenues for obtaining capital in small business. It is not practical to float corporate bonds, to sell corporate stocks or to use other avenues available to the industrial giants. The result, according to an article in American Machinist magazine inserted in the Congressional Record by Senator Nelson on December 19, 1979, is that the smaller manufacturer is trading down. Just as the American housewife is buying cheaper cuts of beef, we are buying stripped down less productive equipment and buying it less often.

Today, the United States, which once had the most modern and sophisticated machine tool population in the world, now has the oldest machine tools of seven major industrialized countries. We have the lowest percentage under 10 years old and the highest percentage over 20 years old.

This has dangerous implications on the national economy. Ours is the industry that supplies the tools, jigs, fixtures, molds, automatic assembly machines essential to virtually every manufacturing company in the country. The productivity of the country's entire manufacturing process is dependent upon the productivity of this industry. Yet, the country's ability to tool up for major manufacturing needs, such as a military crisis, is seriously in doubt.

A major factor that enabled this country to prevail in the Second World War was the ability of our industry to gear up for massive armament production in a short period of time. Today, many other countries are far better equipped than the United States to cope with such emergencies.

What is needed is a comprehensive strategy to encourage investment in the small business. At the White House Conference on Small Business, 2,000 small business persons reduced some 75 priorities to the 15 top needs of small owners. Five of those priorities were in the area of taxation and capital formation. All five made the cut. In fact, the top two were taxation and capital formation.

These proposals make sense, for small business has the greatest potential for improvement in productivity. Incentives for small business will produce the greatest increases in productivity, in innovation and in employment at the least cost in revenue loss to the U.S. Treasury.

Such a package should include an extension of the progressive corporate tax rate with corresponding reductions in the lower brackets. This is the top priority of small business in America. Senator Nelson's S. 2136 would extend brackets to $150,000 and reduce rates in several of those brackets. If enacted, the bill would result in about $3 billion in tax savings for smaller companies earning less than $150,000.

The second part of the package, and the No. 2 priority of the 2,000 delegates at the White House Conference should be to provide for a more rapid write-off of capital equipment. There are currently two proposals; the first is S. 1435, the 10-5-3 bill, introduced by Senator Nelson.

While well-intentioned, it will need an important modification if small business is to benefit from it. Its problem lies in the technique used to phase in the benefits.

To reduce the revenue loss, the authors have used a progressive phase in based on the asset depreciation range for equipment and gradually reduce taxable life for buildings and structures. The problem is that small businesses do not use ADR now due to its complexity, a fact well documented by IRS. The building phase in also unnecessarily complicated for the relatively unsophisticated small business person.

The solution to the problem lies in an approach developed by Congressman Henry Nowak, chairman of the Subcommittee on Access to Equity Capital and Business Capital of the House Small Business Committee. In late February, he introduced H.R. 6617, the Small Business Incentive Act of 1980. Like S. 1435, it reduces the writeoff period for capital assets using slightly different writeoff periods than the 10-5-3 bill.

Where it differs is that it uses ceilings, or caps on the amounts that can be written off at the rapid rates. It uses a 4-year writeoff period with a $1 million ceiling for equipment machinery and vehicles and a 15-year writeoff period with $3 million ceiling on buildings. Amounts in excess of those ceilings would be depreciated at current rates.

It is simple, easy to use, and would have a much smaller impact on Federal revenue than the $75 billion figure estimated by Secretary of the Treasury William Miller on the price for the 10-5-3 bill. If a phasein method using progressive ceilings were incorporated into the 10-5-3 bill, it would then become something which could benefit the small business community.

Since 1975, the first $100,000 of used equipment purchases has been eligible for the 10-percent investment tax credit. Yet many capital intensive small businesses spend many times that amount on used equipment. New equipment often takes too long to get, or is too expensive.

SBLC believes that there should be no discrimination against the age of equipment and that all limits should be removed. S. 2152, introduced by Senator Nelson, would provide an interim solution by doubling to $200,000 the present limit.

As part of the package, several other pieces of legislation should also be enacted. Briefly, they are as follows:

The capital gains rollover bill—S. 653—which would allow tax deferral when a small business owner sells his firm, if the proceeds are reinvested in another small business within 18 months.

A tax credit for the purchasers of newly issued stock of small firms with a net worth of $25 million or less—S. 487 and S. 655—.

A bill to strengthen the financial structure of independent securities firms in order to be able to render capital raising assistance to smaller businesses—S. 1967.

A bill to raise accumulated earnings levels from the current $100,000 limit to $250,000.

An exemption of publicly held venture capital firms from the regulation of the Securities and Exchange Commission under the Investment Company Act of 1940—S. 1940.

A bill creating a new security called a Small Business Participating Debenture which would have the status of a debt security with a stated rate of interest—S. 1481.

Increasing the estate tax exemptions from a maximum of $175,625 to $250,000 by 1981 to encourage continuity of business enterprises—S. 1825.

A bill to preserve family businesses. A related proposal is the National Family Business Preservation Act of 1980 which would change current estate tax laws so that up to one-half to a $500,000 maximum of the value of a family-owned business would be exempt from estate taxes—S. 2220.

Strengthen subchapter S for capital raising purposes, by increasing the permissible number of shareholders from 15 to 100 and allowing issuance of more than one class of stocks—S. 2168.

A reinstatement of tax favored options to broaden the base of ownership in new and small firms and to provide incentives for talented executives to join such venture.

Elimination of the requirement to issue a W-2 form each time a worker changes jobs, allowing all the W-2's to be distributed at the end of the year—S. 2171.

Thank you very much for the opportunity to discuss the status of small business in America. With the help of this committee and the rest of Congress, small business may be able once again to become a strong and healthy part of the American economy.

Senator BYRD. Thank you, Mr. West.

The next witness?

STATEMENT OF WILLIAM HAMBRECHT, CHAIRMAN, SMALL BUSINESS COMMITTEE OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, ACCOMPANIED BY DOUGLAS F. PARILLO

Mr. HAMBRECHT. Mr. Chairman, my name is William R. Hambrecht and I am a partner in the securities firm of Hambrecht & Quist, located in San Francisco, Calif. With me today are Mason T. New, who is the managing partner of the firm of Branch, Cabell & Co. in Richmond, Va. and a member of the board of governors of the National Association of Securities Dealers, Inc.; and Douglas F. Parillo who is a vice president of that same organization.

I am appearing before you today as both a member of the broker-dealer community and as the chairman of the Joint Industry/Government Committee on Small Business Financing, a committee created by the NASD in the fall of 1978 to address the capital-raising problems of small business. Composed of securities industry financing experts, this committee was assisted by representatives of the Securities Industry Association, the Securities and Exchange Commission, the Department of the Treasury, the U.S. Small Business Administration, the National Association of Small Business Investment Companies, the National Venture Capital Association, the White House Conference on Small Business and the Chief Counsel to the Senate Select Committee on Small Business.

The efforts of our joint committee culminated in a Special Report, entitled, "Small Business Financing: The Current Environment and Suggestions for Improvement," which was presented to the U.S. Senate Select Committee on Small Business on May 22, 1979.

With the chairman's permission, I would like to submit the report for the record.

[The material referred to follows. Oral testimony continues on p. 357.]

SPECIAL REPORT

REPORT

of the

JOINT INDUSTRY/GOVERNMENT COMMITTEE

on

SMALL BUSINESS FINANCING

[redacted]

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS INC.

May 22, 1979

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

LETTER OF TRANSMITTAL

May 22, 1979

To Those Interested in the Financing
Problems of Small Business

In September, 1978, the National Association of Securities Dealers, Inc. (NASD) organized a committee of securities industry financing experts to address the capital raising problems of small business. Members of the Committee are William R. Hambrecht (Committee Chairman), Partner, Hambrecht & Quist, San Francisco, California; J. Coleman Budd, Executive Vice President, The Robinson-Humphrey Company, Inc., Atlanta, Georgia; Anthony A. LaCroix, President, Advest, Inc., Hartford, Connecticut; J. Stephen Putnam, President, F. L. Putnam and Company, Inc., Boston, Massachusetts; and, Ernest F. Rice, Jr., Chairman, Executive Committee and Secretary, Blunt Ellis & Loewi Incorporated, Milwaukee, Wisconsin.

In recognition of the constructive work that has been done by other organizations in the area of small business financing, the Committee was expanded beyond the membership of the NASD. In addition to the representatives from NASD member firms, the following individuals, with support from the organizations and agencies they represented, contributed immeasurably to the Committee's deliberations and its final Report. They were Mary E.T. Beach, Bruce Mann, Alfred E. Osborne, Jr., and Linda A. Wertheimer, Securities and Exchange Commission; Donald J. Crawford, Securities Industry Association; Daniel T. Kingsley, National Venture Capital Association; Philip C. Loomis, Department of the Treasury, Office of Securities Market Policy; James B. Ramsey, Jr., U. S. Small Business Administration; Herbert L. Spira, Chief

LETTER OF TRANSMITTAL

Counsel, Select Committee on Small Business, U. S. Senate; Walter B. Stults, National Association of Small Business Investment Companies; and, Linda G. Sundro, White House Conference on Small Business.

The work of the Committee, through its many meetings, was coordinated by the staff of the NASD's Department of Regulatory Policy and Procedures. This group, headed by Douglas F. Parrillo, Vice President, and with substantial contributions from S. William Broka and Thomas P. Mathers, assumed responsibility for drafting the Committee's Report and gathering most of the research material.

It should be apparent to the readers of this Report that all of us who have worked on this project are convinced of the need for action to address the financing problems of small business. The Board of Governors of the NASD plans to extend the life of the Committee in order that it can participate in the implementation of the Report's many proposals. We are heartened by the constructive approach to this problem shown by many different branches and agencies of the government and are hopeful that such a positive approach will lead to favorable results.

In order that the Committee may benefit from the widest possible spectrum of thinking, we sincerely solicit the comments of all persons interested in the subject of capital raising for small business.

J. Stephen Putnam
Chairman

Gordon S. Macklin
President

PREFACE

This Report has been prepared by the Joint Industry/Government Committee on Small Business Financing, a committee which was formed by the National Association of Securities Dealers, Inc. (the "NASD") for the purpose of examining the problems associated with small business financing. During the course of its work, which is now complete, the Committee learned that small business is fast approaching a crossroads—one which could very well determine whether it will continue to serve America as the leading creator of jobs and innovator of technological developments. As discussed in the Report, it is through the small business sector of the economy that our national goals in the areas of employment, economic betterment, opportunity for achievement and an improved quality of life can be accomplished most efficiently and effectively.

Through this Report, the Committee seeks to highlight what it believes are the major problems associated with small business financing and it discusses what it views as viable solutions to those problems. It recognizes, however, that there is likely to be some political sensitivity associated with certain of its recommendations. Notwithstanding this fact, the Committee believes that its recommendations, based in part on the results of a comprehensive nationwide survey of institutional investors and professional portfolio managers, are both sound and practical and, if implemented, will greatly alleviate many of the problems associated with equity financing of small business.

In terms of scope, the Committee's Report identifies and examines the problems of small firm access to the public securities markets. It also discusses the steps that must be taken to improve the environment for bringing small companies public. It does this in the form of recommendations to the Congress, the SEC, the Department of Labor, the states and the industry's self-regulatory organizations.

The first area addressed in this Report is the increased participation in the marketplace by institutional investors whose investment practices tend to discourage investment in small business. The Report reviews the growing concentration of financial and market power in institutions and includes a presentation of the Committee's findings in connection with its special survey of the current investment practices of institutional investors and professional portfolio managers. From this survey, the Committee was able to develop information not previously known. On the basis of this data, the Committee sets forth its recommendations for encouraging institutional investment in small business.

The Report then looks at the withdrawal of the individual investor from the marketplace and the reduced role he now plays. The reasons for this reduction are discussed as are the consequences of a failure to check this trend. A number of approaches are offered for the express purpose of reviving the role of the individual investor.

One of the more ominous problems confronting small business financing is the contraction of the broker-dealer community and the increased concentration of business activity into larger firms. The existence of regional, locally-oriented firms to underwrite the issues of small businesses is essential if such businesses are to gain access to the public markets. As is evident from the data contained in this Report, the number of securities firms has declined dramatically in recent years. The reasons for this are discussed, together with suggestions as to how to reverse this trend.

Another area covered by this Report is the effect of current tax laws on small business investment. The Committee believes that our country's tax structure has discouraged investment in small business by both individuals and institutional investors. This, in turn, has limited small business' access to the public securities markets and made it necessary for such businesses to become more dependent on debt to meet their financing needs. To ameliorate this situation, the Committee has recommended a number of revisions to various sections of the tax code as it applies to small business.

Finally, the cost of equity financing by small businesses has increased tremendously, almost to the point that it has become too expensive for a small firm to attempt to raise capital in this manner. Actions that might be taken to reduce these costs, in addition to those recently proposed and implemented by the SEC, are discussed in this section of the Report.

In conducting its study of the problems associated with small business financing, the Committee drew upon a wide range of informed sources of information. Much of the statistical information contained herein was generated by and obtained from various departments and agencies of the federal government. These included, among others, the Departments of Commerce and Labor, the Small Business Administration, the Securities and Exchange Commission, the Federal Trade Commission, and the Federal Reserve Board. In addition, a number of industry organizations, including the National Association of Securities Dealers, Inc., the National Association of Small Business Investment Companies, the National Venture Capital Association, the New York Stock Exchange, Inc., and the Securities Industry Association, were the sources of valuable data regarding marketplace statistics and investor holdings. Finally, several prominent academicians and knowledgeable professionals in government and industry were consulted by the Committee for their thoughts on the problems of small businesses.

TABLE OF CONTENTS

63-769 O - 80 - 18

CHARTS

TABLES

CHAPTER ONE

SMALL BUSINESS FINANCING: A SERIOUS PROBLEM

INTRODUCTION

Throughout America's history, there have been numerous examples of significant economic development that can be traced to the work of one person or a small group of individuals. All segments of our economy—agriculture, manufacturing, communications, among others—have shared this same experience. Each of these developments began with an idea or dream which was transformed into practical applications through the efforts of those who saw, in the realization of their ideas, a means to wealth, to self-fulfillment, to a better life or to whatever other goal they may have aspired. This freedom to see their dream become reality has made our nation a haven for those who sought to become more than they were. It was this spirit of achievement and excellence personified by those dreamers that gave impetus to America's expansion and fueled her great accomplishments.

Unfortunately, the day of the dreamer may fast be coming to a close. The most effective vehicle for realizing these dreams, small business, is rapidly becoming an endangered species. That such a condition could exist in this country, of all places, is a tragedy. For it to lead to the demise of small business as we have known it would be a crime against our very history and the spirit of economic freedom so intimately intertwined with that history. The small businesses of today and tomorrow are our nation's investment in the future. In the proper environment, they will grow and flourish. In an unhealthy environment, they will wither and die. Small business has and must continue to be the lifeblood of our economic system. Small business and the economic vitality it provides has played a major role in making our nation great.

We do not sound the alarm lightly. The economic realities of our uncertain times are buffeting small business throughout the nation. Inflation, taxation, burdensome regulation, economic concentration through increased merger activity, and the lack of public markets for their securities, among others, are factors which have combined to exacerbate the problems already faced by small business in its day-to-day struggle to survive and prosper within a free market governed by open competition. The imposition of increased burdens on small business through numerous artificially-imposed impediments is detrimental to the economic structure of our society and must be ended before the people's faith in America's economic promise is irreparably damaged.

The members of our Committee are acutely aware of the importance of small business and the severity of its problems. It is because of this awareness that this Report of the Joint Industry/Government Committee on Small Business Financing has been prepared. We have attempted to highlight this area of the economy in order to encourage changes that will effectively address the conditions which threaten the very existence of this critical American resource—small business.

The American public consistently gives the small businessman high marks for honesty, integrity and community spirit and we believe that that same public will support the actions of Congress which will contribute to a stronger, more vibrant small business sector. To this end, our Committee's Report includes a list of recommendations, a number of which require congressional action to become effective. These recommendations are intended to address the major problems confronting small business, especially the problem of securing outside capital for expansion and growth. We are confident that Congress will act with all deliberate speed to effect the Committee's recommendations so that the dreamers of tomorrow will continue to find a haven in America.

STATEMENT OF THE PROBLEM

The ability of small business to obtain equity financing has always been a difficult problem. For example, of the \$6.4 billion raised via common stock offerings in 1977, only \$207 million, or 3.2 percent of the total, was raised by companies offering securities to the public for the first time.[1] Indeed the share of the dollar value of securities offered by smaller issuers to the public on Form S-1, the form most frequently used in registering

[1] *Statistical Bulletin*, Vol. 37, No. 6, p. 33, Securities and Exchange Commission, June, 1978.

securities under the 1933 Act, has remained relatively constant over the last five years. More specifically, the bottom 20 percent of all issuers, ranked from the smallest to the largest on the basis of offering size, received 1.9 percent of the dollar value of securities offered to the public in 1972 as against .8 percent in 1976.[2]

Small companies, particularly those that look to the sale of securities to the public as a source of capital, are usually more difficult to finance than larger firms. They frequently find that they cannot attract the services of larger investment bankers since the amounts they are seeking to raise are too small to be handled profitably by these houses. Many of the costs associated with underwriting a small issue are the same as those for larger ones. Also, the state of the economy and the poor investment performance of the securities markets in recent years have further complicated the plight of small business in its search for much-needed capital.

The problem of inflation is particularly troublesome for capital starved small businesses. Rising prices and wages require greater outlays of capital to finance investment in plant and equipment as well as day-to-day operations. Although inflation imposes the same burdens on small business as it does on large business, the weight of those burdens is far greater for the small business given its limited means for absorbing the impact of ever-increasing costs and prices.[3] Inflationary trends not only exacerbate the capital needs of small business, but they also increase the costs of meeting them.[4]

Other factors have contributed to or have aggravated our nation's capital shortage. For example, the fiscal and monetary policies pursued by the government to fight inflation, i.e., a tightening of credit and the corresponding rise in interest rates, cripples small business. In periods of tight credit, small businesses feel the pressure first. Even if they are able to absorb the high interest costs which they probably are unable to pass along to their customers, they have great difficulty in finding the funds to borrow. This presents an interesting paradox. As Professor Galbraith recently observed, "The industries that depend on borrowed money are characteristically the small firms. . . . Credit is generally vital for the small firm."[5] On this point, an October, 1978, survey by the National Federation of Independent Business (NFIB) found that over 32 percent of 893 small businesses surveyed expected the availability of credit to be diminished during the following three months. The NFIB also found that since July, 1977, credit extended to small business has been getting progressively more costly and more difficult to find. According to the House Subcommittee on Antitrust, Consumers and Employment, "Small Business is not only burdened by the problem of inflation; it is often a hapless victim of the means used to eliminate it."[6]

Inflation has also caused the investor to shift his investments from equities to other investments which bear a lower risk and a higher rate of return. As interest rates rise, credit becomes less and less available to smaller businesses. Spending by all levels of government and the corresponding competition of government with the private sector for available investment capital is a well-recognized cause of today's scarcity. A declining rate of savings and investment, coupled with a rising rate of consumption, further exacerbates the situation.

The effects of all of this are becoming more and more apparent. With a reduced level of investment come decisions by management to postpone expansion, to defer modernization and to slash appropriations for research and development. Higher rates of interest mean higher costs of capital. The high cost of capital also causes firms to place undue reliance on short-term debt as a means of financing their activities. The bottom line of all of this is simply slower economic growth particularly for small business.

In recent years, many of our nation's leading economists have projected a serious and significant capital shortage.[7] When the demand for capital exceeds supply, not only does the cost of what is available escalate, but the pecking order, in terms of whom shall have access to it, leaves small businesses at the lowest end of the scale.

As a result, growing small businesses face the likely prospect of having to sell out, merge with a larger company or continue to operate in an undercapitalized state and run the risk of failure by being unable to withstand periodic downturns in the business cycle.

As to mergers, the most likely candidates are smaller companies and they are generally acquired by firms with substantially greater asset structures. As Table 1 points out, during the period 1972 through 1977, 6,399 companies having assets of less than $1 million were merged with or otherwise

[2] U.S. Securities and Exchange Commission, *New Securities Registrations and Offerings Statistics*.

[3] House Subcommittee on Antitrust, Consumers and Employment of the Committee on Small Business, *Report on the Future of Small Business in America*, H.R. Rep. No. 95–1810, 95th Cong., 2d Sess., p. 30 (1978).

[4] Ibid., p. 23.

[5] Hearings on the Future of Small Business in America Before the Subcommittee on Antitrust, Consumers and Employment of the Committee on Small Business, 95th Cong., 2d Sess. Pt. 2, p. 34.

[6] H.R. Rep. No. 95–1810, p. 30.

[7] In numerous writings, noted economist, Benjamin M. Friedman, Associate Professor of Economics, Harvard University, discussed the problem of increasing capital scarcity and the prospect that given the current environment, it is likely to increase in the years ahead. Other noted economists, industry organizations and government studies have also projected inadequate levels of investment to offset capital needs. In a 1975 Study, the NYSE estimated a $650 billion capital shortage through 1985.

Table 1

Mergers and Acquisitions Completed By Asset Size of Acquired Companies 1972-1977

[In Millions of Dollars]

	1972	1973	1974	1975	1976	1977
Actual Numbers						
$100.0+	17	[illegible]	[illegible]	16	[illegible]	[illegible]
$50 to 99.9	12	19	24	11	21	[illegible]
$10 to 49.9	124	98	78	77	118	161
$1 to 9.9	300	202	166	117	146	148
Under $1 and Unknown	1,661	1,560	[illegible]	660	778	840
Total	2,113	1,919	1,276	889	1,081	1,182
As Percentage of Total						
$100.0+	[illegible]	[illegible]	2%	2%	2%	[illegible]
$50 to 99.9	.5%	.9%	2%	2%	2%	3%
$10 to 49.9	6%	5%	6%	9%	11%	10%
$1 to 9.9	19%	11%	13%	13%	14%	12%
Under $1 and Unknown	74%	80%	77%	74%	72%	71%
Total	100%*	100%*	100%	100%	100%*	100%*

* Detail does not total due to rounding.
Source: Federal Trade Commission, *Statistical Report on Mergers and Acquisitions (1973-1978)*.

acquired by larger companies. This represents over 75 percent of all companies merged or acquired during this period. In terms of those which have done the acquiring, during this same period, Table 2 identifies that companies with assets in excess of $100 million have accounted for about 42 percent of such activity.

Table 2

Mergers and Acquisitions Completed By Asset Size of Acquiring Companies 1972-1977

[In Millions of Dollars]

	1972	1973	1974	1975	1976	1977
Actual Numbers						
$100.0+	730	753	600	398	615	581
$50 to 99.9	272	208	131	98	114	156
$10 to 49.9	580	466	260	164	213	218
$1 to 9.9	254	240	116	58	58	75
Under $1 and Unknown	268	253	169	171	181	152
Total	2,113	1,919	1,276	889	1,081	1,182
As Percentage of Total						
$100.0+	36%	39%	47%	45%	48%	49%
$50 to 99.9	13%	11%	10%	11%	11%	13%
$10 to 49.9	28%	24%	20%	19%	20%	18%
$1 to 9.9	12%	13%	9%	7%	5%	6%
Under $1 and Unknown	13%	13%	13%	20%	17%	13%
Total	100%*	100%	100%*	100%*	100%*	100%*

* Detail does not total due to rounding.
Source: Federal Trade Commission, *Statistical Report on Mergers and Acquisitions (1973-1978)*.

As for the long-term consequences for the economy, inadequate capital formation results in a chain of events beginning with large numbers of unemployed or underemployed people. This, according to Charles D. Kuehner,[1] generates demands for government intervention and spending "to create jobs and income." Without an accompanying expansion in private industry, government intervention accelerates inflation and further weakens the economy. With a slowdown in capital investment, American industry has less to spend on research and development and becomes less competitive in domestic and world markets. Consumers end up with fewer choices of products and services and industry becomes less able to solve such basic problems as energy and pollution. The end of the line for this progression is that the cost of living moves still higher while the consumer demands still more government intervention, controls and spending.

This rather bleak forecast of our nation's economic future is only a forecast—one based upon the present investment environment. If the problems of small business are addressed promptly and sensibly, the chances of this forecast ever becoming a reality will be greatly reduced. Innovative change is needed, however, in a number of areas.

Specifically, if small business is to obtain the capital it needs to survive, it will have to depend to a greater degree on institutional investment. With the declining role of individual investors, institutions now bear a critical responsibility. They must fill the void created by the departure of individual investors who, during the period 1973 through 1978, sold approximately $25 billion more equity than they bought.[2] The future of small business lies in the power of institutions to mobilize large amounts of cash to purchase new offerings of smaller companies and to provide venture capital to those in a developmental stage. For reasons detailed later in this Report, institutional investors have not as yet taken steps to fill that void. Actions need to be undertaken to encourage institutions to become responsive to the capital needs of all sectors of our economy.

As noted, individuals have been leaving the marketplace at an alarming rate. The reasons for this decline of individual investors, discussed later in this Report, are many. Notwithstanding this development, however, individual investors remain a potent force in the economy. Individuals still hold the largest proportion of outstanding stock and direct investments by individuals contribute billions

[1] Charles D. Kuehner (ed.), *Capital and Job Formation: Our Nation's 3rd-Century Challenge*, Dow Jones-Irwin, Homewood, Illinois, 1978, p. vi.
[2] *Prospects for the American Financial Markets in 1979*, Salomon Brothers, New York, 1978, p. 23.

of dollars in new capital each year and provide liquidity for the entire market.[4] The role of the individual investor in the capital-raising mechanism of our economy is extremely important and steps must therefore be taken so as to stimulate his participation in the marketplace.

In order to provide a full range of services to both investors and businessmen, it is critical that there be a strong nationwide network of broker-dealers. The contraction of the brokerage industry since the early 1970's and the growing concentration of business into larger firms is a matter of history. The consequences of this phenomenon, like so many others, is that it hits smaller business the hardest. Many of the broker-dealers that have disappeared through merger or termination are the smaller, local securities firms that provided a full range of services to local investors and local companies. It was these local/regional broker-dealers that brought many local businesses public and provided secondary markets for their securities. Their demise will long be felt by those developing companies that will need their services in the future. Steps must be taken, therefore, to encourage and promote the re-emergence of this vital link in our nation's capital-raising system.

Other impediments to capital formation which affect small business investment must also be addressed. These include rules which constrain institutions and limit their flexibility in making investment decisions. Tax laws also affect investment. Among other things, they impact the ability of business to generate funds for investment internally and to obtain equity capital from outside sources. Government regulations, which prescribe the registration requirements of securities offerings, also inhibit small business investment to the extent the paperwork and related costs of going public are prohibitive. These problems must also be addressed.

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[4] Donald T. Regan, "Promoting Stock Ownership by Individuals," in Charles D. Kuehner (ed.), *Capital and Job Formation: Our Nation's 3rd Century Challenge*, Dow Jones-Irwin, Homewood, Illinois, 1978, p. 278

CHAPTER TWO

SUMMARY OF RECOMMENDATIONS

The following is a summary of the Committee's recommendations for improving the opportunities available for equity financing by small business. Most are directed to the Congress. Others are directed to the SEC, the Department of Labor, the states, and the securities industry's self-regulatory organizations. Several of the recommendations contained in this Report have been developed on the basis of comprehensive studies made by others in government and industry and parallel in certain respects the recommendations which emanated from those studies. Again, this Chapter is simply a summary of the Committee's recommendations. The thinking of the Committee and the data upon which such recommendations are based are described in greater detail in the chapters which follow.

Recommendations to Congress

Tax Laws and the Regulations Thereunder

- Permit the establishment of special tax-deferred reserves similar to those in existence for the banking and insurance industries for broker-dealers engaged in market making as a means of providing improved depth and liquidity to the markets in securities of small and developing companies;
- Further reduce the rate of tax imposed on capital gains to provide for an 80 percent exclusion from taxable income for gains realized from the sale or exchange of investments in businesses which had no more than $5 million of equity capital at the time such investments were made;
- Increase the incentive for investing in small business by allowing the capital gains tax liability from investments in small businesses to be deferred if such gains are reinvested within some prescribed period in other new small business investments [this recommendation is consistent with that contained in S.653, 96th Cong., 1st Sess. (1979)];
- Further reduce the income tax rates and expand the income tax brackets applicable to smaller corporations to enable them to retain a greater proportion of their earnings to finance expansion and capital improvements;
- Encourage investment in Subchapter S corporations by increasing the allowable number of shareholders from 15 to 35, by removing the limitation on the types of shareholders who may invest in such companies and by eliminating the restriction on the availability of Subchapter S treatment for issuers having more than one class of stock outstanding;
- Remove the limitation on the benefits which can be provided under retirement plans of Subchapter S corporations and which are not applicable to any other type of corporation;
- Provide that employees of small businesses shall realize no income at the time stock options are granted or exercised, that the gain on securities acquired through the exercise of a stock option be the excess of the selling price of the securities over their value at the time of grant and, that such gain be recognized as a long term capital gain if the combined holding period for the option and the stock is not less than three years;
- Permit three year accelerated depreciation for purchases of machinery and equipment having a useful life of 36 months or more, up to a maximum of $10,000 per year [this recommendation parallels a proposal contained in S.2742, 95th Cong., 2d Sess.(1978) and with the exception of the amount of property eligible for such treatment, S.110, 96th Cong., 1st Sess. (1979)]; and,
- Establish an investment tax credit for employer contributions to an employee stock option plan (ESOP) in an amount not greater than two percent of the compensation of participating employees.

Employee Retirement Income Security Act (ERISA)

- Amend ERISA to redefine the so-called "prudent man rule" to make clear that the securities of smaller issuers are not excluded from the universe of securities eligible for purchase by funds subject to ERISA. It is recommended that this be done by including in the legislation a specific provision to permit the investment of ERISA subject funds in securities of smaller companies up to some maximum percentage of assets under management. This Committee recommends that the maximum percentage be set at five percent and that the term "smaller companies" be defined to mean any company with a market capitalization not in excess of $50 million.

Federal Securities Laws

- Permit public investment in professionally managed venture capital firms by exempting such firms from the Investment Company Act of 1940 and thus, the various provisions contained therein which make it extraordinarily difficult for venture capital companies to operate successfully under the Act; and,
- Adopt some form of limitation of liability or indemnification for attorneys and accountants rendering services to issuers making securities offerings.

Recommendation to Department of Labor

- As a stepping stone to statutory change, revise existing regulations to apply the standards of prudence to the entire portfolio of an ERISA-subject fund and not specific individual investments contained therein.

Recommendations to the SEC

- Provide some form of limitation on underwriter liability in connection with certain securities registrations, particularly those made using SEC Form S-18;
- In coordination with industry organizations and clearing agencies, continue current efforts to establish a nationwide network of clearing and settlement facilities featuring a cost structure based on geographic price-mutualization;
- Develop policies and/or rules to address properly the problems associated with the volatility of new issue markets; and,
- Insure that the newly created Office of Small Business Policy will have the capability not only to evaluate the technical aspects of new rule proposals but to explore broader issues such as the concerns expressed at the SEC's small business hearings and the impact of existing Commission regulations on small enterprises.

Recommendation to the States

- Adopt a uniform exemption from registration to replace existing state "blue sky" exemptions for exchange-listed securities.

Recommendation to the Securities Industry's Self-Regulatory Organizations

- Continue current efforts to reduce the costs associated with broker-dealer regulation and compliance with a view toward establishing a single self-regulatory organization for the industry.

CHAPTER THREE

SMALL BUSINESS: ITS CONTRIBUTION TO THE ECONOMY AND ITS JOURNEY TO MATURITY

THE ROLE OF SMALL BUSINESS IN THE NATION'S ECONOMY

"Small business is traditionally the sector of the economy where expansion of industry and job development go hand-in-hand. Small business is the essence of our free enterprise system." Those are the words of America's leading small businessman, President Jimmy Carter. His statement expresses in rather succinct terms the genesis of this Report. The importance of small business to the nation and the American people cannot be overstated. Through the drive, creativity and spirit of individual entrepreneurs, the economy of this great nation grew from its simple agrarian beginnings to the most dynamic and diverse economy in the world.

That the economy is dynamic is evident from the enormous amount of goods it produces and services its provides. By the end of 1978, the current dollar value of the nation's Gross National Product exceeded $2.2 trillion with personal consumption accounting for almost two-thirds of that amount. The consumer spent over $760 billion on durable and nondurable goods as well as some $640 billion on services.''[11] No other nation in the world approaches the aggregate productive output of our economic system. This result is a direct consequence of our free enterprise system which allows every individual to maximize his potential and realize his goals through hard work, determination and the desire to succeed.

The efforts of individuals to respond to the demands of the free marketplace provide our economy with its immense diversity. This economic diversity is achieved to a great extent through the efforts of entrepreneurs whose small businesses encompass a substantial sector of the economy. Small businesses account for 55 percent of all private employment, 48 percent of the nation's business output, 43 percent of GNP, and more than half of all industrial inventions and innovations.'[12] According to the Small Business Administration, in 1975, small business (excluding farms) operated a total of 10,232,000 businesses, or 96.7 percent of the total of all businesses, and had annual business receipts of $3.3 trillion, or 53.5 percent of all business receipts.'[13]

According to a 1968 Commerce Department study, small business accounted for more than half of all scientific and technological developments since the beginning of this century. Also, a National Science Foundation study, which covered the period between 1953 and 1973, found that small firms produce about four times as many innovations per research and development dollar as medium-sized firms and about 24 times as many as the largest firms.

Small business is also the nation's job creator. Recent studies by the Massachusetts Institute of Technology and the American Electronics Association disclosed that the rate of growth in hiring among small high-technology firms ranged between 24 and 40 percent, nearly nine times that of employment growth in other sectors of the economy.'[14] According to a recent House Subcommittee report, the sum of the effect of small business on employment is almost 66 times the effect of larger business.'[15] These figures help to highlight the importance of small business to the economic health of the country.

The U. S. Small Business Administration considers a firm to be "small" and eligible for SBIC financing if its assets do not exceed $9.0 million, if its net worth is not more than $4.0 million, and, if its average net income after taxes for the preceding two years was not more than $400,000. However, for purposes of this Report, a business is considered "small" if it has a market capitalization, i.e., the market value of securities outstanding, of

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[11] *Survey of Current Business*, U. S. Department of Commerce, Bureau of Economic Analysis, Washington, February, 1979, Volume 59, Number 2, page S-1.

[12] *Hearings on Capital Formation Before the Select Committee on Small Business of the United States Senate*, 95th Cong., 2d Sess., Part 1, February 10, 1978, p. 93.

[13] *Small Enterprise in the Economy*, U. S. Small Business Administration, Washington, June, 1978, Inside Cover.

[14] House Subcommittee on Antitrust, Consumers and Employment, *Report on the Future of Small Business in America*, H.R. Rep. 95-1810, 95th Cong., 2d Sess., November 9, 1978, p. 7 (Union Calendar No. 944)

[15] Ibid., p. 8.

$50 million or less. Fifty million dollars in market capitalization was selected by the Committee as a breakpoint for distinguishing between "large" and "small" business since, as demonstrated later in this Report, issues which fall below the level are normally excluded from the investment portfolios of many institutional investors. This factor, coupled with a myriad of other factors discussed in succeeding chapters of this Report, has left this category of issuer starved for equity capital. Because of this, the Committee has determined to address the financing predicament of all businesses having a market capitalization of $50 million or less.

THE LIFE CYCLES OF A GROWING BUSINESS AND ITS SOURCES OF FINANCING

For a small business to develop, it must have an adequate supply of capital, preferably long-term capital, to help it implement its business plan, to provide it with sufficient current assets during the period that the business is being established and to provide it with the capital necessary for growth and expansion.

In a 1977 SBA Task Force Report on Venture and Equity Capital for Small Business, the life cycles of a growing business en route to corporate maturity were described in some detail. As indicated in Chart 1 and as described in the SBA Report, each stage in the life of a business enterprise requires a different type of capital. To provide this capital and to fulfill these financing needs, small developing companies have historically looked to commercial banks and other lending institutions, venture capital groups and investment bankers for assistance. Financing through commercial banks and other lenders is normally sought to fill intermediate or short-term needs. This is not permanent capital, but rather, temporary financing via term loans. It is also a limited source of capital, since the amount of debt financing available to a business is directly tied to its equity base. The availability of this type of financing in terms of cost is also tied to the prevailing rate of interest.

Apart from borrowing money, the only other method available to business for raising capital is to sell ownership interest in it, i.e., to sell equity. With debt financing limited by a company's equity base, new equity or risk capital must be obtained if the life cycle of the company is to proceed without interruption. For small and developing companies, the opportunities for growth are often well beyond their ability to finance themselves. They must therefore look to others. Venture capital groups generally provide risk financing to businesses in this stage of development, i.e., businesses which have expanded beyond the initial or start-up phase—the phase normally financed by the owners of the company, friends of the owners, relatives, and others having a special interest in the company.[14] Investment bankers also fulfill a financing need by providing equity capital to firms which are generally more firmly established.

Generally speaking, the longer a firm is in business, the more likely it is to succeed and the lower the risk associated with an investment in it. As a corollary, the longer a firm is in business, the more successful it is, and the larger its equity base, the easier it is for it to fill its financing needs from its own earnings, by selling additional equity or by borrowing. As a result, those that need capital the most, i.e., smaller companies in the early stages of development, experience the greatest difficulty in obtaining it. Because they are incapable of generating the capital needed to support their growth, potential small developing companies are forced to obtain outside assistance.

As indicated in Chart 1, public financing is not normally available to a company until it has achieved a minimum of $10 million in revenue. This has not always been the case. In recent years, there has been an upward shift in the amount of revenue needed before a public offering could take place. In the '60's, all that was needed was an idea.

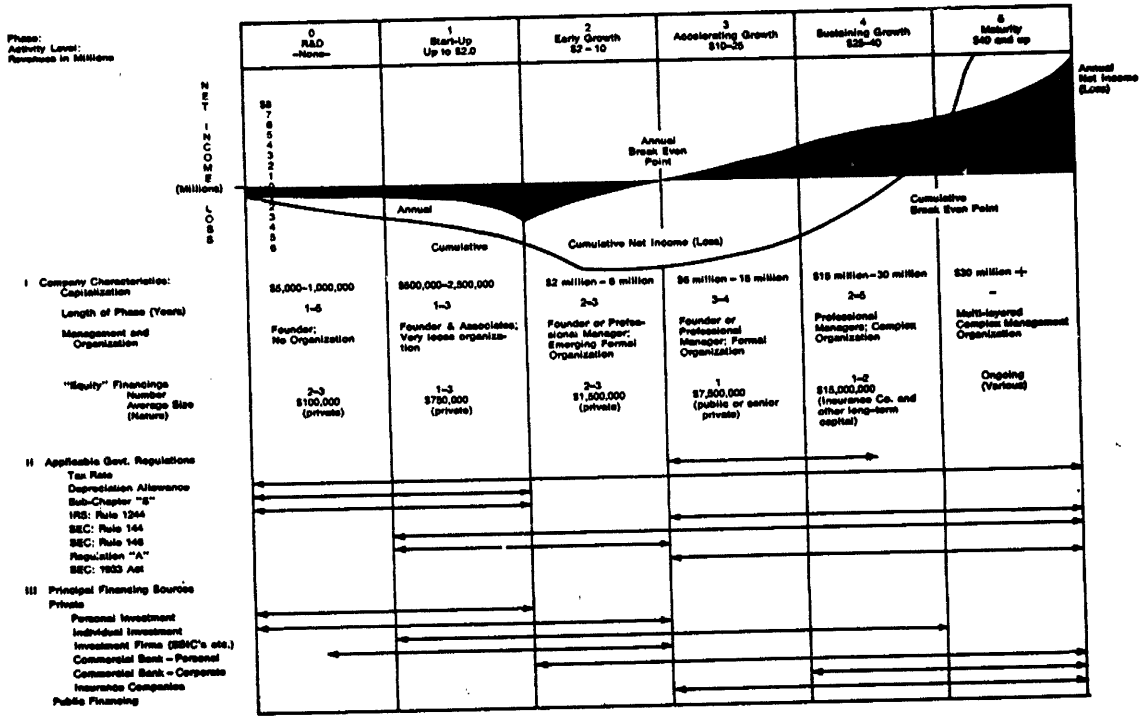
Venture capital groups usually provide the transition between personal investment and public investment by obtaining and providing financing for a small, developing company after it has brought or is about to bring its product into production, has developed some commercial interest, and has established a small line of bank credit. This is known as "first stage financing."

Venture capital groups also provide what is known as "second stage financing." This is provided to companies which are producing and shipping; whose accounts are growing and whose marketing expenses are increasing. At this stage, the need is primarily for working and expansion capital; for, although it is growing, the company may still be operating at a loss. At the third stage of development, a firm is generally breaking even or making a profit. Financing at this point is intended to provide funds for further plant expansion, marketing, working capital or perhaps acquisitions. Following this stage, another form of financing, known as "bridge financing," begins. It normally occurs when a company is six months to a year from going public, i.e., securing external financing for a business through the sale of stock to the public. Such financing is usually structured so that the funds borrowed via the bridge financing

[14] Stanley M. Rubel, "Venture Capital Investment," in Sumner N. Levine (ed.), *Financial Analyst's Handbook I: Methods, Theory and Portfolio Management*, Dow Jones-Irwin, Homewood, Illinois, 1975, pp. 488–600.

CHART 1

LIFE CYCLE OF A NEW ENTERPRISE
MODEL OF A GROWING AND SUCCESSFUL COMPANY
1975–1976 FINANCIAL MARKET CONDITIONS



Source: *Report of the SBA Task Force on Venture and Equity Capital for Small Business*, U. S. Small Business Administration, January, 1977.

can be repaid from the proceeds of the public underwriting.[17]

Should a company determine to go public, it will enlist the services of an investment banker to facilitate the company's transition from a private enterprise to a public corporation. The investment banker agrees to buy the securities being issued or arranges placements of them in order to provide the issuing corporation with the funds it requires. In the case of small offerings of securities, an underwriting firm will purchase the securities itself for subsequent resale to the public. For larger offerings, an investment banking firm will establish an underwriting syndicate and a selling group to facilitate the placement of the issue. In addition to setting up a distribution network for the offering, the investment banker renders advice and many other services to issuers.

After the underwriting is complete, frequently one or more members of the syndicate will act in the capacity of dealer by making a market in the securities of the issuer. Many consider it a part of their function to maintain a secondary market. By standing ready to buy and sell the securities of an issuer in the market, an over-the-counter market in the issue is created.

Going public is the pay-off for the venture capitalist since it liquifies his investment. From the perspective of the issuing company, it is perhaps the most important step it can take on the road to maturity. It is the step in the financing process that gives validity to those which precede it. It gives the issuer new permanent capital in the form of increased equity investment and new borrowing capacity via an improved debt to equity ratio. If a firm finds that it cannot go public, the pressure to liquify the investment is likely to force a merger.

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[17] Ibid

CHAPTER FOUR

INSTITUTIONAL INVESTORS: THEIR GROWTH AND THEIR INVESTMENT PRACTICES

During the last 20 years, the level of trading by institutional investors has increased to the point that they are the single most dominant force in our nation's securities markets. While the long-term effects of this increased level of institutional activity are unclear at the moment, one thing is for certain—our securities markets are undergoing significant change. Among those being impacted by this restructuring are small businesses and those seeking to achieve access to the public securities markets. For a variety of reasons, many of which are discussed below, the Committee has found that a substantial number of institutional investors and professional portfolio managers follow investment policies which discourage or overlook investment in the securities of the smaller companies. In light of projections that institutions will hold over 50 percent of all public securities by 1985, it appears to be a foregone conclusion that smaller companies will face even more difficult times in the years ahead in seeking to finance normal growth, modernization and expansion. This is the likely scenario unless, of course, institutions change their investment practices and become more willing to invest in smaller companies.

The data contained in this section of the Report, evidencing the growing concentration of securities trading by institutions, was obtained through a variety of sources, including the aforementioned survey conducted by this Committee of institutional investors and professional portfolio managers. The data developed by this study is new information which documents and quantifies for the first time the extent of the financing problem facing small business. Many of the reasons which underlie the negative bias of institutional investors toward small business investment and the steps which this Committee believes must be taken to encourage institutional investment in small business are discussed in this section of the Report.

GROWING CONCENTRATION OF FINANCIAL AND MARKET POWER IN INSTITUTIONS—A 20-YEAR SURVEY

There is much evidence to confirm that over the last 20 years, the financial and market power of institutions has increased dramatically. For example, according to data compiled by the SEC, the total market value of outstanding stock, both common and preferred, was approximately $1 trillion as of December 31, 1977. Of this amount, over 31 percent, with a market value of $311 billion, was owned and/or controlled by institutional investors.[18]

Table 3

Market Value of Stockholdings of Institutional Investors and Others [In Billions of Dollars, Year End]

	1960	1965	1970	1975	1977
Private Non-Insured Pension Funds	$16.5	$ 40.8	$ 67.1	$ 86.6	$101.9
Insurance Companies (Life & Casualty)	12.5	21.1	26.6	42.3	50.0
State and Local Retirement Plans	.4	1.6	10.1	24.3	30.0
Investment Companies	20.6	41.1	50.1	44.0	38.3
Bank Trust Departments	44.6	73.2	85.2	86.9	90.1
Totals	94.9	177.8	238.1	286.1	311.3

Source: Securities and Exchange Commission.

Included in these figures are life and fire and casualty insurance companies which have increased their holdings from $12.5 billion in 1960[19] to $50 billion in 1977.[20] Holdings for private non-insured pension funds grew from $16.5 billion in 1960[21] to over $100 billion in 1977,[22] while the holdings of

Table 4

Total Assets Managed by Institutional Investors and Others [In Billions of Dollars, Year End]

	1960	1965	1970	1975	1977
Private, Non-Insured Pension Funds	$ 38.1	$ 73.6	$110.6	$ 148.9	$ 186.6
Insurance Companies (Life & Casualty)	149.7	200.7	[illegible]	363.4	408.8
State and Local Retirement Plans	19.7	34.6	[illegible]	104.7	130.5
Investment Companies	28.6	44.5	[illegible]	74.1	77.6
Bank Trust Departments	*	*	298.5	387.2	606.7
Totals	—	—	781.2	1,106.3	1,[illegible]

[illegible] Insurance Institute, American Council of Life Insurance, [illegible] Deposit Insurance Corporation, Federal Reserve [illegible] and Exchange Commission.

[18] *Statistical Bulletin*, p. 10–11.
[19] [1972] *SEC Ann. Rep.*, p. 151.
[20] *Statistical Bulletin*, p. 11.
[21] [1972] *SEC Ann. Rep.*, p. 151.
[22] *Statistical Bulletin*, p. 11.

state and local retirement funds went from $0.4 billion [23] to $28.1 billion [24] during this same period.

The amount of assets under management or held in trust is another indicator of both actual and potential market power. For example, the amount of assets held in trust by commercial banks has increased from $288.5 billion in 1970 to over $500 billion in 1977.[25] Also, since 1960, mutual fund assets have increased from slightly under $24 billion to nearly $77 billion in 1977. Private pension fund assets have grown more dramatically. In 1960, the assets of private pension funds totaled $38.1 billion. Today, these plans have assets in excess of $185 billion with state and local government employee retirement funds controlling another $147 billion for a total of $354 billion. Over $274 billion of this amount consists of outstanding corporate stocks and bonds.[26]

More evidence of the growth of institutional influence in the securities markets can be found in data compiled by the NYSE. As indicated in Table 5, by the end of 1975, institutions held $230.5 billion worth of NYSE-listed issues. This represented an increase of 44 percent over the $160 million held by institutions in 1969 and an increase of 89 percent over the $122.1 billion held by such investors in 1965. Since the major stock market indices have shown very little change over this same period, it is reasonable to assume that this substantial growth in institutional holdings is due mainly to new investment and not price appreciation.

Table 6 provides further evidence of increased institutional participation in our nation's securities markets. As indicated in that table, institutions, which had accounted for 33 percent of the trading volume and 38.7 percent of the dollar volume on the NYSE in 1961, were responsible for over 57 percent of the NYSE's trading volume and over 70 percent of its dollar volume by 1976.[27] This increase was also accompanied by a dramatic rise in the size of the average NYSE transaction. In 1970, the average number of shares per transaction appearing on the NYSE ticker tape was 388. That figure had risen by over 27 percent in 1975 to 495 shares per transaction. By 1977, the average NYSE transaction had increased to 641 shares per transaction—a staggering 65 percent increase over the 1970 figure.[28]

Block transactions are another indicator of growing participation in the securities markets by

Table 5

Institutional Holdings and Block Transactions in NYSE Issues 1969–1977

Year	Market Value of Institutional Holdings (Million of $)	% of Total NYSE-Listed Issues	[illegible] Transactions
1969	$1[illegible]	[illegible]	[illegible]
1970	[illegible]	[illegible]	[illegible]
1971	21[illegible].7	[illegible]	[illegible]
1972	[illegible]	[illegible]	[illegible]
1973	[illegible].7	[illegible]	[illegible]
1974	171.0	[illegible]	[illegible]
1975	$230.5	[illegible]	[illegible]
1976	—	[illegible]	[illegible]
1977	—	[illegible]	[illegible]

Source: New York Stock Exchange.

Table 6

Institutional Trading [illegible] of Volume and Dollar [illegible] Traded on [illegible] Selected Years 19[illegible]

	As a Percentage of Shares Traded	[illegible]
1961	[illegible]	[illegible]
1963	[illegible]	[illegible]
1965	[illegible]	[illegible]
1968	[illegible]	[illegible]
1969	[illegible]	[illegible]
1974	[illegible]	[illegible]
1976	57.[illegible]	[illegible]

Source: New York Stock Exchange.

institutions. In 1976, a total of 47,632 block trades involving 1,001,254,000 shares valued at approximately $29 billion took place on the NYSE. During 1977, the number of block trades on the NYSE increased to 54,275. These trades involved 1,183,924,000 shares valued at almost $34 billion. From this data, a parallel between historic block activity and the increase and decrease in the shares outstanding of NYSE-listed issues held by institutions can be drawn.[29]

As noted in Table 5, for each year in which the market value of institutional holdings rose or fell, there was a corresponding rise or fall in the number of block sized transactions effected on the NYSE. Although the figures for the market value of institutional holdings and percent of total NYSE-listed issues held by institutions for 1976 and 1977 are not presently available, it would appear reasonable to conclude from an extrapolation of the historical block data that the percentage of institutional ownership of NYSE securities similarly in-

[23] [1972] *SEC Ann. Rep.*, p. 161.
[24] *Statistical Bulletin*, p. 11.
[25] *Trust Assets of Insured Commercial Banks*, Federal Deposit Insurance Corporation, Washington, 1968-1977 editions.
[26] *Flow of Funds Accounts 1946–1975*, Board of Governors of the Federal Reserve System, Washington, December, 1976, p. 126; *Flow of Funds 1978 Outstanding—Preliminary*, Board of Governors of the Federal Reserve System, Washington, February, 1979, pp. 563–564.
[27] *1974 New York Stock Exchange Fact Book*, p. 55; *1976 New York Stock Exchange Fact Book*, p. 54.
[28] *1978 New York Stock Exchange Fact Book*, p. 10.

[29] Ibid., p. 71.

creased in 1976 and 1977. This, coupled with the NYSE's estimates for institutions not included in its published computations, provides added evidence of a growing concentration of economic power in the large financial institutions.[30]

SPECIAL SURVEY OF THE CURRENT INVESTMENT PRACTICES OF INSTITUTIONAL INVESTORS AND PROFESSIONAL PORTFOLIO MANAGERS

In order to quantify the magnitude of the problem of small business financing, the Committee, with the assistance of Price Waterhouse & Co., independent certified public accountants, conducted a survey of over 1900 institutional investors and professional portfolio managers, including bank trust departments, insurance companies, investment companies/mutual funds, independent money managers and college endowment funds. The purpose of the survey was to develop information not previously known about the investment policies, practices and preferences of these various categories of investors. The survey consisted of 13 questions designed to elicit relevant data regarding the types of investments being made by these investors as well as their reasons for such. A copy of the survey questionnaire and related material is appended to this report as Exhibit A. A report prepared by Price Waterhouse & Co., analyzing the results of the survey as well as a detailed numerical breakdown of the numbers and types of survey responses is also attached as Exhibit B.

Approximately 30 percent of those surveyed responded. This is an exceptionally high rate of return for a voluntary survey of this nature, particularly since there was a fair amount of overlap, in terms of common management, among many of those surveyed. From its review of the data received, the Committee believes that it now has information which provides a fairly accurate measure of the current investment attitudes and practices of a majority of the country's institutional investors and professional portfolio managers.

ANALYSIS OF SURVEY RESULTS

The following is an item-by-item summary of the responses received from 558 respondents. A total of nine of the 558 were submitted on behalf of 46 companies. These were tabulated as nine responses.

Question 1: What is the nature of your operation?

A total of 537 individual responses were received to Question 1 representing 558 answers (some respondents checked more than one type of business activity). A total of 84 out of 186 national bank trust departments, or 45.2 percent of those surveyed, responded. Twenty-four out of 89 colleges and university endowment funds, or 27.0 percent of those surveyed, returned questionnaires. Of the 609 investment companies surveyed, 132, or 21.7 percent of those sent questionnaires, responded. A total of 316 out of 1056 insurance companies surveyed, or 29.9 percent, replied. Also, a total of 26 independent money managers and 13 other entities returned survey questionnaires. The Committee was extremely pleased that over 45 percent of bank trust departments responded to its request for information. These entities control the single largest portion of professionally managed investment funds subject to ERISA in this country. In the opinion of this Committee, the extremely high rate of return, in this and other categories of those surveyed, forms a valid basis from which numerous findings can be made and upon which certain conclusions can be drawn.

Question 2: What are the sources and percentages of investment funds managed?

Of the 537 responses received, 516 provided information on the sources and percentages of investment funds which they manage. Of this total, 376 indicated that individual investors were a prime source of the funds they handle. On the average, individuals provide approximately 80 percent of the total investable funds of these organizations. Pension plans were a major source of investment funds for 261 respondents (many of the respondents to the survey have more than one source of investment funds) and such plans constituted an average of about 28 percent of the total funds they manage. Institutions were the third largest source of funds of those responding to the survey. A total of 175 said they managed the funds of institutional customers and that these monies represent 36 percent of the total funds they presently have under management. A final category entitled "Other" was indicated by 123, or 24 percent, of all respondents. Examples of such "Other" sources of funds include corporate trusts, union funds, reserves, surplus funds and investment companies, among others. The fact that such a large percentage of managed funds is contributed by individual investors supports the Committee's conclusion, detailed later in this Report, that investors are making indirect investments in professionally-managed accounts through pension funds, savings plans and other similar investment vehicles with the result being that a reduced level of discretionary income is available for direct pur-

[30] New York Stock Exchange Fact Books, 1972-1978.

chases of equity and debt products. It also supports the Committee's contention that professionally-managed accounts are becoming so much a part of our economic system that the growth of these plans will probably continue to increase for the foreseeable future.

Question 3: What is the approximate dollar value of assets currently managed (in millions of dollars)?

The Committee's inquiry regarding the dollar value of assets currently managed by members of the survey population produced a broad range of responses. While almost 60 percent of the respondents (302) indicated that the portfolios they manage are valued at $250 million or less, the remaining 40 percent (233 respondents) reported asset figures which ranged from more than $251 million to over $10 billion. Seventy-two out of 84 responding bank trust departments said they managed assets in excess of $251 million. The only respondents with assets in excess of $10 billion were in the bank and insurance company categories.

Question 4: What percentage of assets currently managed is subject to Employee Retirement Income Security Act (ERISA)?

Of the 514 responses received to this question, 410 respondents, or 79.8 percent of the total, indicated that less than 25 percent of the assets which they manage are subject to ERISA. It is assumed that many of these 410 respondents do not manage any ERISA-related funds. Unfortunately, the survey form was not designed to allow a negative or zero response. Of those which said that less than 25 percent of the assets they manage were subject to ERISA, 254 were insurance companies, while another 19 were college endowment funds, 98 were mutual funds, 36 were bank trust departments and eight were independent money managers. In view of the nature of their business activities, it is quite probable that the majority are unaffected by ERISA. As the survey data clearly documents, out of all of the categories of institutions surveyed by the Committee, only bank trusts and independent money managers have more than a nominal portion of their assets subject to ERISA constraints. More specifically, only 40 of 514 respondents (7.8 percent) stated that more than 50 percent of their assets are ERISA related.

Question 5: Of the total assets managed, what amount is currently invested in common stocks?

This question was designed to give a clear-cut indication of the perceived attractiveness of common stock investment on the part of both institutional investors and professional portfolio managers. A significant proportion of the respondents answering this question, 53.8 percent, noted that less than 25 percent of the total assets which they manage are invested in common stock. Almost 75 percent of all respondents indicated that common stock investments make up less than 50 percent of their investment portfolios. Only 63 of the 532 institutions which answered this question (11.5 percent) noted that they have more than 75 percent of their assets in equity securities.

An examination of this question by individual categories shows that 63 percent of bank trust departments, 58 percent of college endowments and 96.5 percent of insurance company respondents have less than 50 percent of their assets in common stocks. Only investment companies/mutual funds and independent money managers show significant investments in equities. A total of 66 percent of mutual fund respondents and 53.8 percent of the independent money managers have more than one-half of their assets in equities.

Question 6: What percentage of these common stock holdings would you estimate is invested in the following types of equity securities?

This question was intended to provide information as to the specific types of common stock investments held by institutions. The responses indicated a marked bias in favor of securities of larger companies. Out of 509 respondents, 500 (98 percent) stated that they held NYSE-listed stocks. These institutions indicated further that on the average such securities comprised over 86 percent of their equity holdings. In terms of popularity, over-the-counter securities displayed on the NASDAQ System ranked second. Such securities were held by 357 institutions (70.1 percent of those responding to Question 6). They reported that such investments constituted an average of slightly less than 11 percent of all equity securities held. Securities lised on the AMEX were held by 260 respondents or approximately 51 percent of those surveyed, and, on the average, such investments amounted to 7.82 percent of respondents' equity positions. Securities traded over-the-counter but not displayed on NASDAQ, those traded on regional stock exchanges, and those over-the-counter stocks for which there was no existing public market were held by 161 respondents, or 32 percent of the survey population. The survey data clearly documents that institutional investors are disinclined toward investment of significant amounts in securities of companies which are not among the nation's largest and most broadly capitalized.

Question 7: What percentage of new money received in 1978 has been invested in equity securities?

Sixty-three percent of those answering this question (329 of those surveyed) invested less than 25 percent of new money received in 1978 in equity securities. This rather low percentage may be due in part to the large number of insurance companies which responded to the survey and the fact that the reserves they maintain are invested subject to various restrictions imposed by state insurance commissions. Approximately 72 percent of the bank trust departments responding to the survey noted that they invested between 25 and 75 percent of new money received in 1978 in equity securities. Although no statistics are maintained by the bank regulatory authorities as to the amount of new money inflows to bank trust departments, by virtue of the sheer size of their assets alone, it can be assumed that the equity investments they collectively made during 1978 were of considerable size and impact. Of the investment company/mutual fund respondents, 33 percent (36 funds) invested less than 25 percent of new monies in equity securities, while another 25 percent (another 28 funds) invested between 25 and 75 percent of such equities. The remaining 46 investment company respondents (41.8 percent of *all* funds answering this survey) placed over 75 percent of the assets acquired in 1978 in equities.

The above data documents two facts. First, it evidences the significant participation in the marketplace by institutional investors. By comparing the responses to this question to those of Question 5, it can also be seen that new money is being invested in equities at rates below the percentages of equity investment currently held in the portfolios of such institutions. While the equity investment percentage rate of institutional investors appears to be declining, at least in relation to the current makeup of institutional portfolios, other data suggest that the overall dollar value of equity investments continues to increase. In other words, institutions appear to be investing more money in equity products but at declining rate of growth.

Question 8: Do you have any policy, either formal or informal, which requires a minimum level of market capitalization for companies in which you invest?

According to the survey data, the existence of policies which delineate investment criteria with respect to market capitalization appears to be widespread among institutional investors and professional portfolio managers. With the exception of college endowment funds, the majority of respondents in every category indicated that they had such a policy in effect. Most, however, said their policies were informal. Bank trust departments led this group with 81 percent reporting that they had some form of policy. Also, 66 percent of the investment company/mutual fund firms responding to the survey stated that they operated under such a policy. In addition, 51 percent of insurance company respondents and 72 percent of independent money managers said they, too, followed some type of policy relating to minimum capitalization standards. Of the college endowment funds, 71 percent indicated that they did not operate under any policy, either formal or informal.

Question 9: If your response to Question No. 8 was "yes," what is the minimum market capitalization standard your organization has established (in millions of dollars)?

Of the 307 responses received to this question, there were only two categories in which the majority of respondents indicated that their policies permitted them to invest in securities of firms with a minimum market capitalization under $50 million. These were investment companies/mutual funds with 55 percent so responding (42 out of 77) and college endowment funds of which five out of seven indicated that they would invest in firms with capitalization of under $50 million. Only eight out of 19 independent money managers and 19 out of 67 bank trust departments followed policies which permit investments in securities having a market capitalization of less than $50 million. Only 48 out of 142 insurance companies, or 34 percent, have policies which permit investment in companies with less than $50 million capitalization. The survey has made it very clear that the large majority of institutional investors have discriminatory policies against investment in small business as that term is defined in this Report.

Question 10: If you do not invest in companies with a capitalization of less than $50 million, please indicate the reasons for such by ranking them from "most important" (1) to "least important" (8), as applicable?

All but one of the categories of respondents rated "Lack of Liquidity" as the number one reason for not investing in such companies and the one group, independent money managers, which did not rate it first, rated it second. "Lack of Independent Research" and "Price Volatility" were rated second and third, respectively, as reasons why investment in companies with a market capitalization of less than $50 million were not made. "Difficulty in Valuation" was rated fourth. "Lack of Financial History" of the issuer, "Cost of In-House Research" and "ERISA Concerns" were the remaing reasons cited by the survey respondents for not investing in these smaller companies.

The liquidity problem is one with which this Committee is vitally concerned and for which it has developed several recommendations. Those are discussed later in this report.

In citing inadequate research on small companies, it would appear that institutional investors are saying that research on these companies is either unavailable or that the cost of preparing it in-house is not cost effective. The Committee recognizes this to be a serious problem and one which must be overcome if small business is to get its share of investment funds.

In analyzing the responses to Question 10, it was noted that the answers vary according to the category of respondent. For example, while ERISA was cited as the least important reason by all respondents for not investing in companies with a market capitalization of less than $50 million, bank trust departments, i.e., those having the greatest amount of ERISA-subject money, rated ERISA concerns as the fifth most important reason why they shy away from small business investment. The other categories of respondents have very little in the way of ERISA-subject funds. The reasons which bank trust departments rank #1, #2, #3 and #4—"Lack of Liquidity," "Lack of Independent Research," "Price Volatility" and "Lack of Financial History," respectively, are, in many respects, simply another way of saying "ERISA Concerns," since these are the very factors which influence portfolio performance and the efforts of ERISA-subject fiduciaries in seeking to minimize risk and maximize return.

Question 11: Would you favor a change in ERISA or in the administration thereof to encourage investment in small companies (i.e., securities which are presently excluded from your universe of investment to the extent ERISA is a factor)?

The fact that ERISA is considered an impediment to investment in small business is further evidenced by the responses received to this question. Over 38 percent of the 521 respondents to this question favored amending ERISA or the administration thereof to encourage investment in small business, while only 13.6 percent recommended that no changes be made. The remaining 48 percent had no opinion on the issue. The high rate of those responding with "no opinion" appears consistent with the fact that many of these institutional investors and portfolio managers handle funds which are not subject to ERISA.

Question 12: If your response to Question No. 11 was "yes," do you favor either of the following?

A. Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."

The question of whether legislation should be adopted to amend the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a five percent "basket clause," received support from over 85 percent of the respondents to this question (171 out of 201 responses). As to the individual categories, bank trust departments supported a change in the "prudent man rule" by 30 to 3. Responding insurance companies also were in favor of a change by a margin of 88 to 9. All other categories were similarly in favor of a change in the prudence standard prescribed by ERISA by overwhelming margins.

B. Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration.

As to the question of whether revisions in the present regulations of the Departments of Labor and Treasury relating to overall portfolio administration were needed, the answer was a resounding "yes." The aggregate response indicated that over 86 percent of those answering this question favored revisions in the regulations (152 out of 175 responses). Within the individual categories, the support for this proposal was substantial. For example, 44 out of 51, or 86 percent, of the investment company/mutual fund respondents supported administrative change. Of the bank trust departments which responded, 29 out of 33, or 88 percent, favored revision of the regulations. Insurance companies expressed support for the alternative by a margin of 70 to 10. As with the "basket clause," the remaining groups favored this proposal by substantial majorities.

The responses to these questions show a high degree of confusion on the part of fiduciaries as to what the prudence standard means and how it relates to small business investment. The message is clear. These investors desire both legislation and administrative action as a means of ending this confusion.

Question 13: What other incentives, if any, do you favor to encourage small business investment?

Of all the responses received, the one incentive favored by the majority of respondents (336, or 64 percent of those surveyed) was legislation to provide additional capital gains tax relief. Within the individual categories, the support was even more pronounced. Seventy-three perçent of bank trust departments (61 out of 83) and 81 percent of the independent money managers (20 out of 25) made this recommendation. In addition, 74 percent of the investment companies/mutual fund group (87 out of 118) also called for reduced capital gains tax. With regard to the question of whether legislation was needed to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses, a total of 147 respondents, or 28 percent, said they were in favor of such.

GENERAL CONCLUSIONS

There is nothing on the horizon to suggest that institutions will play a reduced role in our nation's securities markets. On the contrary, all the evidence tends to suggest that their assets will continue to grow and they will play a more dominant role in our securities markets. While the Committee certainly does not object to the growing role of institutions, it does believe that small business, on the basis of the data it has uncovered, is not receiving a fair share of the investment dollars institutions control and manage, at least not in proportion to the contribution small business makes to the nation's economy.

This Committee is also of the opinion that the federal pension law is, in large part, responsible for the institutional bias against investment in small business. With the enactment of ERISA in 1974, a complete overhaul of pension and employee benefit rules took place. Generally speaking, ERISA affects virtually every pension or other employee benefit plan. The law established mandatory rules for plan participation as well as alternative vesting procedures and higher, more stringent minimum funding standards. In addition, ERISA also increased plan reporting requirements, designated certain prohibited transactions, and tightened fiduciary rules.[31] It is these fiduciary rules with which this Committee is primarily concerned.

[31] *Pension Reform Act of 1974—Law and Explanation*, Commerce Clearing House, Inc., New York, 1974, p. 2.

Under the Act, all fiduciaries are required to discharge their duties solely in the interest of the plan's participants and beneficiaries. Under penalty of personal liability, they are compelled to replace any losses resulting from a breach of fiduciary duty and they must return any profits made through the illicit use of the plan's assets.[32] To provide fiduciaries with some guidance as to what constitutes an appropriate investment, ERISA states that fiduciaries must act with the care, skill, prudence and diligence that a prudent man would use under similar circumstances.

The Committee believes, as demonstrated by the data developed from its survey, that these provisions of ERISA serve to discourage investment by institutions in the securities of small businesses. The cause of this is quite simple. Individuals charged with the responsibility of managing large institutional portfolios find comfort in investing in high grade, blue chip securities thought to offer low risk in order to avoid any possibility of violating the comprehensive fiduciary standards of ERISA. Although a number of other factors are certainly at work in tandem with ERISA, such as the availability of adequate outside research and market liquidity, it is a statistical fact that since 1974, the percentage of trust assets of commercial banks invested in common and preferred stock declined 13 percent to 51 percent in 1977.[33] Given the prudent man rule and its perceived emphasis on low-risk investments, one can reasonably assume that this divestment of stocks did not include to a great extent the AT&T's and IBM's of the securities markets.

The detrimental effect of ERISA on venture capital, a substantial source of start-up funds for small business, is documented by a recent survey conducted by the National Venture Capital Association. As shown in Table 7, venture capital money from sources subject to ERISA regulation declined sharply from 33.7 percent of the total money raised during a pre-ERISA period to 6.8 percent after the adoption of ERISA—a drop of almost 80 percent. This drop occurred despite a $56 million increase in the size of the venture capital funds surveyed. The slack caused by this shortage of ERISA money appears to have been picked up in part by foreign investment which arose from zero participation to over ten percent while bank holding companies increased their involvement by eight percent. In the opinion of this Committee, reliance on foreign investment in high technology firms is questionable and possibly inconsistent with the national interest since it transports those technologies out

[32] Ibid., pp. 98–100

[33] *Trust Assets of Insured Commercial Banks*, Federal Deposit Insurance Corporation, 1975 and 1977 editions

Table 7
Sources of Venture Capital [illegible]
(In Millions of $/[illegible])

No. of Funds and Date		Individual Sources: Indi-vidual & Family	Edu-cational Endow-ment	Non-Financial Corpo-rations	[illegible] Banks	[illegible]	[illegible]
Three (3) Funds Formed In Late 60's To Early 70's Pre-ERISA		$ 6.85	$4.25	$ 1.[illegible]	$ 1.1[illegible]	[illegible]	[illegible]
		5.3%	4.0%	1.[illegible]%	1.1%	[illegible]	[illegible]
Eleven (11) Funds Formed In 1977–1978 Post-ERISA		$38.66	$6.25	$22.4	$1[illegible]	[illegible]	[illegible]
		23.6%	3.9%	12.[illegible]%	9.[illegible]%	[illegible]	[illegible]

* Foreign

** Of the $11 million ERISA Funding in 1977–1978, $5 million came from funds managed by [illegible] invested in the venture capital funds, e.g., special situations. The six million $ remainder came [illegible]

Source: National Venture Capital Association.

of this country. It points out, however, the serious inability of these companies to raise capital here.

The requirement for fiduciaries to make every effort to assure that the monies entrusted to them realize the greatest possible return with the minimum amount of risk is well understood. Unfortunately, those charged with making these investment decisions have mistakenly concluded that under ERISA, issues which are not among the most-highly rated or which do not possess a long-established earning history may be viewed as securities of questionable quality, the purchase of which could conceivably result in expensive and prolonged litigation. Although this is an incorrect interpretation of ERISA standards, it is nonetheless a view which is prevalent among many of these investment managers.

RECOMMENDATIONS

In order to insure the viability of American industry in world markets, the Committee believes the following steps must be taken to encourage greater investment by institutions in small and developing companies.

- **Amend ERISA to Redefine "Prudent Man Rule"**

  On the basis of its survey, the Committee recommends that ERISA be amended to redefine the "prudent man rule" to make clear that the securities of smaller issuers are not excluded from the universe of securities eligible for purchase by funds subject to ERISA. On this point, the Committee was heartened by the comment of a representative of the American Bankers Association in recent testimony before a Senate subcommittee when he said:

> "The trustee's duty is to manage the assets that have been specifically set aside to provide retirement benefits at a future date. In choosing particular investments the trustee must take into account all the present facts and circumstances and the prospects for the future. Additionally, ERISA requires that the investments be diversified so that the risk of loss is minimized. Thus, in picking the investments which make up a particular portfolio there is no built-in bias toward any particular type of security. The portfolio consists of a mix of securities chosen in such a way as to minimize the level of risk of the portfolio as a whole and to maximize the potential for income and capital appreciation. ERISA's prudent man rule allows for investment in all types of businesses including small and locally situated ones. If there are local investments which offer good economic prospects and

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an acceptable level of risk, the trustee is free to choose them." [34]

In the opinion of this Committee, affirmative action in the form of legislative change and administrative action is urgently needed so as to remove the confusion that surrounds the issue of small business investment.

For those individuals responsible for making investment decisions on behalf of institutions, the legislation must clarify, once and for all, that investments in smaller companies by ERISA-subject accounts do not in any way conflict or violate the prudence requirements to which all ERISA fiduciaries are subject. Without question, securities should be purchased by fiduciaries on the basis of economics, i.e., appreciation potential and present and projected rates of return. Securities should not be included or excluded from any investment list or from investment consideration solely on the basis of an issuer's size and a national following. In addition, the legislation should be amended further to make clear that the prudence standard applies to the entire managed portfolio and not specific or individual investments contained therein. By emphasizing overall portfolio performance and not the performance of individual components of a portfolio, institutional investment in small business would be greatly encouraged. To insure that small business receives its proper share of the investable funds of institutions, this Committee would support inclusion in the legislation of a so-called "basket clause" along the lines of that previously proposed in legislation introduced by Senator Lloyd Bentsen on January 18, 1977, (S.285, 95th Cong., 1st Sess.) and by Congressman John J. LaFalce on October 11, 1977, and May 10, 1978, in H.R. 9549, 95th Cong., 1st Sess. and H.R. 12666, 95th Cong., 2d Sess., respectively. From our survey, of those responding to the question of whether the "prudent man rule" should be amended to permit some percentage of assets managed to be invested in small companies, over 85 percent, or 171 out of 201, answered "yes." For those with higher concentrations of ERISA-subject funds, the percentage in favcr of such an amendment was slightly higher.

No matter how many times the "prudent man rule" is defined or interpreted, there will always be some doubt or uncertainty. Unless the uncertainty in the mind of those responsible for making investment decisions is removed through some form of affirmative action, small business will continue to be ignored and excluded from the investment portfolios of institutional investors. In the opinion of this Committee, the solution lies in the adoption of a basket clause. It would remove the perceived barriers to small business investment by providing pension fund managers with a clear assurance that investments in small business are indeed appropriate for inclusion in a managed portfolio subject to ERISA and that it is in the nation's interest to do so.

- **Revise Existing Department of Labor Regulations Relating to Overall Portfolio Administration of ERISA-Subject Funds**

The Committee, as well as over 87 percent of those responding to this survey question, support the effort of the Labor Department to clarify the intent of ERISA with respect to the "prudent man rule." Rules which apply the prudence standard to the entire portfolio and not to specific investments contained therein are both appropriate and necessary. In that connection, it is our understanding that the proposals which are now being finalized by the Department of Labor will set forth the following fundamental factors to be considered by a fiduciary when judging the quality of an investment:

- the composition of the plan investment portfolio with regard to the diversification of risk;
- the volatility of the portfolio with regard to general movement in investment prices;
- the liquidity relative to the projected payment schedule for benefits; and,
- the prevailing and projected economic conditions of the investments.[35]

In the opinion of the Committee, these are reasonable criteria to which fiduciaries should be subject.

- **Develop Incentives to Encourage Risk Market Making To Improve the Depth and Liquidity of Markets**

The Committee further recommends that broker-dealers be provided with incentives to make markets so as to increase the depth and liquidity of the markets for securities of smaller issuers. Clearly, the single most important

[34] Statement of Jerry D. Minton, Senior Vice President, First National Bank of Fort Worth, on behalf of the American Bankers Association before the Subcommittee on Citizens and Shareholders Rights and Remedies Committee on the Judiciary, U. S. Senate, November 22, 1978

[35] *Congressional Record*, 95th Cong., 2nd Sess., April 26, 1978, Senate, pp. 6420-6423

finding from the Committee's survey is that institutional investors are extremely concerned over the marketability of investments in smaller companies. This was the principal reason cited by respondents (153 out of 223) as to why they did not invest in companies with a capitalization of less than $50 million. In order to bring about increased marketability and liquidity of small business investment, incentives to encourage market making by existing firms and new entrants to the securities business are needed. One such incentive strongly recommended by this Committee is the establishment of special tax-deferred reserves for market makers similar to those in existence for the banking and insurance industries. The purpose of such reserves would be to provide a broker-dealer with some protection against losses incurred in his performance of the function of risk market making. This proposal embodies the concept of tax deferral, not tax avoidance. More specifically, the Committee recommends that a broker-dealer be allowed to defer taxes on his market making profits up to $1,000,000 and that the specific amounts that may be set aside in such a reserve account be not more than 30 percent of the market value of average equity positions carried for market making purposes. For the average firm, it would take a substantial period of time to reach its maximum level. If this proposal had been in effect during 1977, a total of 487 broker-dealer market makers would have been able to defer somewhere in the vicinity of $20,000,000 in tax liabilities, or about $40,000 per firm, on gross revenues from market making in over-the-counter securities of approximately $330 million. Hence, the impact on the Treasury due to lost revenues would be negligible. The 30 percent standard which the Committee proposes is identical to the deduction prescribed in the SEC's net capital rule (a rule to which all broker-dealers are subject) to decrease the value of equity positions owned by a broker-dealer in the evaluation of its financial viability. This percentage deduction, or haircut, as it is known, is included in the SEC rule, along with other percentages for other types of securities, to provide a cushion against adverse price movements in securities owned by a broker-dealer. The use of reserves would serve to smooth out the tax consequences which accrue to the broker-dealer community, particularly smaller broker-dealers, by recognizing the cyclical nature of the securities business. The reserve would provide a much-needed cushion during periods when markets are declining and the need for a viable market making community the greatest. By the way of example, assume that the precipitous decline which took place in the securities markets during the last quarter of 1978 occurred in January, 1979. What would have happened is that firms would have been forced to pay taxes out of funds which had been depleted due to deteriorating market conditions.

The issue which the Committee is addressing with this proposal is not simply one of a reduction in broker-dealer capital, but more seriously, an impairment of capital. Clearly, the maintenance of a viable universe of independent market makers, particularly those serving smaller businesses, is an integral part of our nation's capital-raising system.

In this connection, the Committee further recommends that these tax-deferred reserves be non-transferable, i.e., that they would not accrue to the surviving or acquiring firm in the case of a merger or acquisition. The effect of this would be to create an economic incentive for broker-dealers making markets not to merge (a discussion of the need for a nationwide network of independent broker-dealers appears later in this Report).

The availability of tax reserves will encourage broker-dealers to make markets. It will strengthen their capacity to make more and better markets and, in turn, aid the economy by promoting capital formation. Clearly, the ability of a small business to issue securities is directly tied to the prospect of an aftermarket in those securities—one with adequate depth and liquidity. The Committee's survey of institutional investors documents that fact. An investor is not likely to buy a security he cannot sell or one that he would only be able to sell at a sharply-reduced price. A key solution to the problem of small business financing, therefore, is to insure the existence of highly competitive secondary markets in the securities of issuers of all types and sizes. With improved aftermarkets for securities brought public will come an improved environment in which new issues of small and developing companies can be brought public.

- **Effect Tax Reform In Areas Which Will Encourage Investment In Small Business**

The Committee's recommendations concerning tax reform measures are discussed in greater detail in a later section of this Report dealing with the impact of current tax laws on small business. However, since certain of these recommendations would provide substantial encouragement to institutional investors to invest in small businesses, they are touched upon in this section of the Report. They are as follow:

- Adoption of additional capital gains tax relief;
- Adoption of tax incentives to encourage the reinvestment/roll-over of capital gains from small business investments into other new small business investments; and,
- Adoption of additional income tax deductions for small businesses.

This Committee believes that the adoption of these, as well as the other proposals which are discussed more fully in the section addressing tax issues, will promote small business investment by institutional investors.

CHAPTER FIVE

WITHDRAWAL OF THE INDIVIDUAL INVESTOR FROM THE MARKETPLACE

INDICATORS EVIDENCING REDUCED ROLE OF INDIVIDUAL INVESTORS IN THE MARKETPLACE

"Our economy cannot survive without the participation of a large number of individual investors. . . . All companies, small and large . . . depend upon the individual investor to supply liquidity, depth and continuity to the market." [16] This statement, by Senator Lloyd Bentsen, Jr., (D-Texas) expressing his concern over the need to revive the role of the small investor is indicative of the Committee's own findings that participation in the marketplace by a large number of individual investors is important to the well-being of small business. Although the problem has been widely discussed, there has been very little in the way of analysis done to explain why the individual investor is withdrawing from the marketplace, what factors have precipitated his withdrawal and what must be done to reverse this trend.

The actual withdrawal of the individual investor from the marketplace can easily be documented through a number of sources. One such source, the NYSE, conducted a survey in 1975 which revealed that for the first time since 1952, the year the NYSE began compiling such data, the number of shareowners in the United States did not increase.[17]

As indicated in Table 8, there was a dramatic decline in that number—NYSE figures disclosed that one out of five investors has left the marketplace since 1970. In terms of actual figures, shareowners decreased by 5.6 million—from 30.9 million in 1970 to 25.3 million in 1975.[18]

Of interest, too, is the fact that the individual investor who has remained in the marketplace has shifted a significant portion of his investment funds away from equities to high yield, fixed income investment According to data compiled by Salomon Brothers, and as indicated in Chart 2, individual households have been the net sellers of approximately $25 billion in equity securities over the last six years. During this same period they have purchased over $216 billion U. S. government and agency securities, issues of state and local governments, corporate and foreign bonds and other fixed income securities.[19]

Table 8

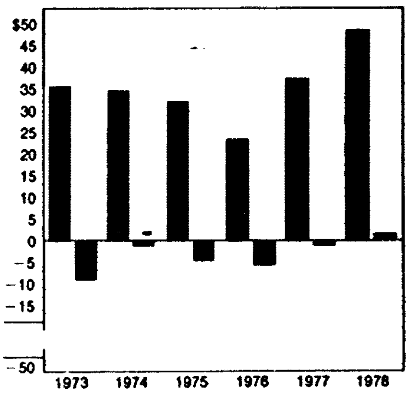
**Increase/Decrease in Shareholders
Selected Years 1952-1975**

Survey Year	Number of Individual Shareholders (thousands)	% Increase (+); Decrease (—) From Previous Survey Year
1952	6,490	—
1956	8,630	+33.0%
1959	12,490	+44.7%
1962	17,010	+36.2%
1965	20,120	+18.3%
1970	30,850	+53.3%
1975	25,270	−18.1%

Source: New York Stock Exchange.

CHART 2

**Net Direct Investment by Households in Debt and Equity Issues
1973–1978
(In Billions of $)**



■ Debt ■ Equity

Source: Salomon Brothers, *Prospects for the American Financial Markets in 1979.*

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[16] Lloyd Bentsen, Jr. *Reviving the Role of the Small Investor* *The Conference Board Record* New York, April 1975 p. 32
[17] *1978 New York Stock Exchange Fact Book* p. 50
[18] Ibid

[19] *Prospects for the American Financial Markets in 1979*, Salomon Brothers, New York, 1978 pp. 23 and 35

In the face of this clearly-evident trend in the decline of individual investor interest in equity investment, one may quite properly raise the question of why the securities industry failed to take note of the situation and seek to develop programs and/or new products either to stem or to reverse this tide. The fact of the matter is that it did. The NYSE and, more recently, several major banks, inaugurated investment plans aimed largely at attracting the small or individual investor. These plans, however, met with little success and most institutions, including the NYSE, later abandoned these programs due to a lack of interest. The lack of success of these programs is yet another indication of the movement of the individual investor away from the securities market.

CONTRIBUTING FACTORS TO THE WITHDRAWAL OF THE INDIVIDUAL INVESTOR

One of the principal causes of the withdrawal of the individual investor from the marketplace has been the state of the economy and the uncertainty surrounding it, particularly since the 1973 oil crisis. The subsequent increases in the cost of energy and the corresponding impact of double-digit inflation on personal savings and investment has been devastating. Investors have had to assume a defensive posture, choosing to avoid "unnecessary" risk taking by placing available funds in vehicles which promise the greatest immediate rate of return with the least opportunity for erosion of principal and purchasing power. The rather poor investment performance of the equities markets is directly related to the nation's economic health. Inflation affects real profits and such is reflected in securities prices. From the end of 1973 through 1978, the Consumer Price Index (CPI) rose 52.4 percent or an average of 10.5 percent per year.[40] During that same period, the Dow Jones Average of 30 Industrials experienced a net loss of 16.1 points, a 2.0 percent decline. However, as compared with its month-end high of 1,027 in January, 1973, the Dow Jones Industrial Average declined over 20 percent.[41] The NYSE Index and Standard & Poor's Combined Index, on the other hand, experienced gains over this same period. They were, however, slight at 3.6 percent and 1.4 percent, respectively. As hedges against inflation, the securities of larger companies, as measured by these indices, have not fared very well. The over-the-counter market, however, where the bulk of the country's publicly held small businesses are traded, has enjoyed somewhat better results. At the end of 1973, the NASDAQ Composite Index stood at 92.19. At year-end 1978, it had climbed to 117.98, a 28 percent increase over five years. During this same period, the price/earnings ratios for some 800 NASDAQ stocks followed by Media General's Financial Weekly progressively declined from 14.3 to 8.1, suggesting that the earnings of these companies were increasing at a rate substantially in excess of their increases in per share prices. In the opinion of this Committee, the strength and performance of the over-the-counter market has been largely unnoticed by most investors.

Another factor which has contributed to the withdrawal of the individual investor from the marketplace was the Tax Reform Act of 1969, which, among other things, increased capital gains taxes 60 percent.[42]

A recent survey by the NYSE covering public attitudes toward investing confirmed that "the American Public, shaken by inflation and fearing more to come, is deeply cautious about managing its money."[43] Generally, the persons surveyed stated that they preferred passbook savings, saving certificates, real estate and life insurance to investing in stocks. The Committee believes that this trend is supported by Salomon Brothers' data regarding the flow of funds from equities into high yield, fixed income investments. It is the Committee's view that this flow will no doubt continue until inflation is brought under control. Inflation has made it harder for the investor to save and has made other forms of investment at least temporarily more appealing.[44]

The shift in investor interest away from common stocks has also been hastened by the increased participation by employees in pension funds, thrift plans and profit-sharing trusts, by the advent of new vehicles, including exchange-listed options and by the mass media marketing of money market funds. Not only has the amount of savings invested in equities been reduced by the affinity of individual investors for higher yield debt instruments, but equities must now also compete with a growing number of alternative investment vehicles, many of which offer tax benefits, professional management and diversification of investment. At this point in time, the trend toward managed accounts in the form of pension funds and savings plans and less independent investing is so pervasive in our society that even if changes

[40] *1977 Business Statistics*, 21st Biennial Edition, U.S. Department of Commerce, Bureau of Economic Analysis, Washington, D.C., March 1978, p. 43; *Survey of Current Business*, p. S-8.
[41] *1977 Business Statistics*, p. 106; *Survey of Current Business*, p. S-21.
[42] *Tax Policy, Investment and Economic Growth*, Securities Industry Association, New York, March 1978, p. 64.
[43] *Public Attitudes Toward Investing*, New York Stock Exchange, New York, June 1978, p. 5.
[44] From Remarks by James W. Davant, Chairman of the Board, Paine Webber, Inc., in a speech entitled *The Individual Investor: Will Our Capital Markets System Work Without Him?*, before the Executives' Club of Chicago, February 28, 1975.

are made and the market improves, it is quite possible that the individual may not return to his prior level of pre-eminence as he no longer finds it necessary to fund his own retirement. The decrease in the incentive to save because of pension funds and other similar vehicles as well as fewer broker-dealers to bring him advice means that the individual investor may not return to the marketplace en masse even if the economic conditions that caused him to leave are resolved.

The amount of funds actually channeled by individuals into savings instruments of all types has also declined in recent years. An examination of personal savings as a percentage of total disposable personal income during the period 1973 through 1978 reveals that the individual savings rate experienced nearly a 32 percent decline, falling from 7.8 percent of disposable income in 1973 to 5.3 percent of that figure in 1978.[45] Thus, the trend toward more spending and less saving has itself had a deleterious effect on the amount of funds available for equities investment. There is a real need, therefore, to make savings a more palatable alternative primarily through a reduction in the rate of inflation but alternatively, by increasing the attractiveness of capital investment.

While inflation has been pinching the pocketbooks of investors, it has also been taking its toll on the broker-dealer community. Increased costs of providing a full range of services to a declining number of investors has become extremely burdensome to the industry. As reported by the SEC, for broker-dealers with total revenue of $500,000 or more, expenses increased approximately 78 percent during the period 1970 through 1976 with the largest single increase coming between 1974 and 1975.[46] Of the types of expenses examined by the SEC, the item showing the most prolific gain was "operating expenses." This figure, exclusive of communications, occupancy and rental and promotional costs, jumped almost 123 percent in 1975 alone.[47] Increasing costs have pushed firms to consolidate their operations, to contract the level of services they offer, and to search for potential merger candidates as a means of offsetting surging expenses.

Public confidence in the securities industry has also been suggested as a possible cause of withdrawal of the individual investor from the marketplace. From all indications, it would appear that the public is not particularly well educated about the highly-regulated environment in which their broker-dealers operate and the protections provided their investments by the Securities Investor Protection Corporation (SIPC), an organization formed under the Securities Investor Protection Act of 1970. To what extent this lack of knowledge influences an individual's investment decisions is difficult to measure. It is clear, however, that investors know much more about the merger wave which has swept the industry and the fact that today there are fewer firms in the securities business than they do about how the securities industry actually functions.

In the previously mentioned NYSE survey of investor attitudes, it was reported that "misunderstanding and lack of knowledge about most types of securities investments critically influence public attitudes toward, and participation in, the market."[48] In this connection, barely one quarter of all "financial decision markers" surveyed considered themselves knowledgeable about common stocks. In view of this finding, it would not appear unreasonable to assume that most investors, lacking a strong understanding of investment strategy and theory, place a great deal of trust in their brokers to make decisions on their behalf and to manage their funds appropriately. To the extent that brokers are successful in satisfying their clients, investor confidence grows. A record of poor performance will, on the other hand, lead dissatisfied customers to shift their resources to other money managers for investment, possibly in areas unrelated to the securities industry. With this thought in mind, the Committee reviewed the past several years in order to detect events which could be deemed to have affected investor confidence in some fashion. Foremost on the list of such events has been, in the Committee's opinion, the seemingly high failure rate of broker-dealers during the first part of this decade. According to information available from SIPC, a total of 130 of its members were placed in trusteeship between 1971 and year-end 1978. Of those liquidations, 94, or 72 percent of the total figure, occurred between 1971 and 1973 with a record 40 during 1972 alone. In this connection, over 250,000 customers accounts received the protection of SIPC.[49]

Conditions in the brokerage industry have improved dramatically in recent times to the point where only two firms faced SIPC liquidation in 1978. Nevertheless, the Committee believes that the problems encountered by broker-dealers during the early 1970's caused a large, but as yet undetermined, number of customers who were also affected by those problems to change their

[45] *Flow of Funds Accounts 1949–1975*, p. 1; *Flow of Funds Accounts 4th Quarter 1978*, p. 1.
[46] [1977] *SEC Ann. Rep.*, p. 283.
[47] *Ibid.*

[48] *Public Attitudes Toward Investing*, p. 6.
[49] Data supplied by the Securities Investor Protection Corporation.

attitudes toward the securities markets and participation in them. Further complicating the drain on public confidence occasioned by the liquidation of a number of broker-dealers has been the widespread publicity which both regulators and self-regulators give to the announcements of formal disciplinary actions against broker-dealers and their registered personnel who have been found to have violated federal securities statutes and/or the rules of the various self-regulatory organizations.

Bank regulators, on the other hand, do not announce the actions taken or sanctions imposed against those they regulate. They contend that to do so would be to undermine depositor confidence in the nation's banking institutions. In marked contrast, the securities industry operates on the premise that disclosure of actions taken against those persons regulated inspires investor confidence. The Committee has, however, uncovered little evidence to support that assumption. In fact, it appears that disclosure of disciplinary actions has had quite the opposite effect on individual investors.

GENERAL CONCLUSIONS

Participation in the marketplace by individual investors is important to the well-being of small business. Small issuers are dependent upon individual investors for equity investment and for needed depth and liquidity in the markets for their securities. The Committee is convinced, however, that unless major steps are taken to encourage investment and unless progress is made to stabilize the nation's economy, the trend toward fewer individual investors active in the marketplace will continue.

RECOMMENDATIONS FOR REVIVING THE ROLE OF THE INDIVIDUAL INVESTOR

The Committee has prepared a series of recommendations which it believes could serve not only to halt the decline in individual investor participation but could also result in a return of investors to the marketplace. Its recommendations are as follows:

- **Further Reduction in the Capital Gains Tax Rate**

  On November 7, 1978, President Carter signed into law the Revenue Act of 1978 (H.R. 13511). One of the key aspects of that legislation was the reduction which it provided, effective November 1, 1978, in the rate of tax imposed on capital gains. Under the new law, the maximum rate of regular income tax on net long term capital gains was reduced to 28 percent. Although this was certainly a step in the right direction, the Committee is of the view that Congress must do more on both a long and short range basis to stimulate investment in small business. Rewards must equate with risk. To the extent that tax legislation does not distinguish between gains from investments in seasoned versus unseasoned companies, a disincentive to invest in small companies exists. Since the principal reason for investing in small business is the potential for capital appreciation and not income, investors must be provided with a greater reward for investing in such companies. They involve greater risk. In the opinion of this Committee, larger capital gains benefits for small business investments would attract the capital neded by small business for expansion, modernization and growth.

  Since the thrust of the Committee's concern is the enhancement of investor interest in small business, the Committee recommends that an 80 percent exclusion from taxable income be made available to capital gains realized from the sale or exchange of investments in businesses which had no more than $5 million of equity capital at the time such investments were made. The maximum rate of regular income tax on these gains would be reduced to 14 percent (20 percent of the top 70 percent rate).

  As an alternative to an across-the-board reduction in the capital gains tax rate, the Committee would support a graduated capital gains tax package similar to the graduated tax rate presently applied to corporations on the basis of the amount of their taxable income.[36] Pursuant to this approach, a maximum exclusion from capital gains tax of 80 percent down to a minimum exclusion of 60 percent could be established. As is presently the case, the scale would be arranged in accordance with the size of the business as of the time the investments which produced the capital gains were made. The smaller the business, the larger the exclusion.

- **Establishment of a Tax-Deferred Reserve for Securities Market Makers**

  As noted in the preceding section of this Report, the Committee supports the establishment of a tax-deferred reserve for securities market makers. Reserves of this type

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[36] H. R. 13582, 95th Cong., 2nd Sess.; S. 1815, 95th Cong., 1st Sess.

should serve to hasten the return of the individual investor by encouraging market making and by keeping the smaller, local broker-dealer viable to make investment recommendations about small companies. Such would add increased depth and liquidity to the equities marketplace and expand the avenues of investment opportunity and professional opinion available to investors.

- **Public Investment in Professionally Managed Venture Capital Firms**

In order to tap new sources of risk capital, the Committee suggests that consideration be given to permitting public investment in professionally managed venture capital firms. Congress sought to do this when it developed the SBIC program as a source of venture capital for small firms. However, the intent of Congress has been frustrated by the Investment Company Act of 1940 (the "Act") under which all publicly-held SBIC's must operate. Those that do operate in this mode have largely provided investment loans to small businesses. As a result, there are no SBIC's registered under the Act that are true venture capital companies.

Today there are less than 100 privately financed venture capital firms which supply practically all the funds available for new company formation in this country. Their number is, however, insufficient as the need for business development capital far exceeds the supply. Additional funds must be channeled through venture capital enterprises and into the hands of growing business concerns. Public investors can supply these funds if given the opportunity to make direct investments in venture capital firms. As with the SBIC's, the 1940 Act is the source of the problem for the privately financed venture capital companies seeking to go public. The provisions of the Act which they find particularly burdensome are those addressing asset valuation and those which limit management compensation, the percentage of a fund's assets which may be invested in a single company and the percentage interest in a company which a fund may acquire. This Committee is of the opinion that venture capital companies could make a greater contribution to the growth of small business if they could have access to public markets. This can only be done by relieving such companies from 1940 Act compliance. The Committee strongly recommends that this be done.

- **Capital Gains Rollover for Investment in Small Business**

If an investor were permitted to defer taxes on gains realized from small business investments, if reinvested in other small businesses, it is anticipated that such action would renew individual investor interest in the stock market and, in particular, small business. Although this recommendation is discussed in greater detail in Chapter Two, it is mentioned here because of its importance in, and potential for, revising the role of the individual investor.

CHAPTER SIX

CONTRACTION OF THE BROKER-DEALER COMMUNITY AND INCREASED CONCENTRATION OF BUSINESS ACTIVITY INTO LARGER FIRMS

INDICATORS OF A GROWING DECLINE IN THE POPULATION OF SECURITIES FIRMS

In the preceding chapter the contraction of the broker-dealer community through an increased number of mergers, consolidations and liquidations was cited as both a contributor to and an accelerator of the individual investor's withdrawal from the securities markets. Many of these have been firms with a regional orientation. A reduction in their number has served to reduce the opportunities available to the public for investing in the securities of local and smaller businesses. Should the contraction of the broker-dealer community, particularly with respect to those firms in the underwriting and market making business (the principal risk-taking areas of the industry), continue at its present rate, investors and issuers alike will suffer from a decrease in effective competition and a narrowing of available investment choices.

As indicated in the following tables, the actual number of firms conducting a securities business has declined appreciably since 1970. New York Stock Exchange members have declined by 76 (13.3 percent) in eight years, while firms engaged in over-the-counter securities activity (generally smaller firms), as measured by membership in the NASD, have fallen an incredible 37.1 percent from 4,470 in 1970 to 2,813 by year end 1978. Also, the

Table 9

Membership—National Association of Securities Dealers, Inc. (NASD)

Year	Broker-Dealers	% Decline From 1970	Branch Offices	Total Locations	% Decline From 1970
1970	4,470	—	6,990	11,460	—
1971	4,320	3.3%	6,756	11,076	3.4%
1972	4,118	7.9%	6,619	10,737	6 3%
1973	3,666	18 0%	6,498	10,163	11 3%
1974	3,166	29.2%	5,990	9,156	20.1%
1975	2,893	35.3%	5,949	8,842	22 8%
1976	2,877	35.6%	6,949	8,826	23 0%
1977	2,772	38.0%	6,144	8,916	22 2%
1978	2,813	37.1%	6,327	9,140	20 2%

Source: NASD Annual Reports.

Table 10

Member Organizations—New York Stock Exchange (NYSE)

1970 — 572
1971 — 577
1972 — 558
1973 — 523
1974 — 508
1975 — 494
1976 — 481
1977 — 473
1978 — 496

Source. New York Stock Exchange

number of locations from which NASD members conduct a securities business has experienced a similar decline during this period, dropping from 11,460 to 9,140 or more than 20 percent. Of particular concern to the Committee is the fact that while these figures portray overall trends in the industry, an analysis of specific industry segments such as the number of firms engaged in a general securities business and those broker-dealers participating in underwriting syndicates, areas of particular importance to individual investors and small business issuers, shows that such segments have been especially hard hit in recent years.

In a recent paper on this subject, Professor Samuel L. Hayes, of Harvard University's Graduate School of Business, discussed in some detail the extent of the decline in the number of broker-dealers involved in equity financing between 1971 and the present. He noted that although there has been relative stability at the upper end of the underwriting syndicate hierarchy since the beginning of the 1970's, ". . . the sub-major bracket [the second tier of firms reflected in the tombstone announcements of securities offerings appearing in the financial press], which has historically provided the vital retail distribution capacity for an underwriting syndicate and which in 1971 had 23 participants, has virtually disappeared as a result of the waves of mergers and liquidations in the industry."[51] Those who are affected most by this loss of underwriting capacity are the prospective issuers from among the nation's busi-

[50] Samuel L. Hayes, III, The Transformation of Investment Banking" Harvard Business Review Vol 57, No 1, p 166 Harvard University, Boston, Massachusetts January-February 1979
[51] Hayes p 157

nesses. In effect, they are being denied an opportunity at new issue financing due to the withdrawal of broker-dealers from the underwriting business. This decline in underwriting firms has also been accompanied by an actual decline in public financings. As noted by Professor Hayes, between 1971 and 1977, public corporate financings dropped from $38.6 billion to $36.6 billion and estimated gross underwriting revenue fell from $841 million to $735 million.[12]

Especially hard hit by the increased number of mergers and consolidations among broker-dealers have been issuers located outside of major metropolitan areas. These issuers have been extremely dependent upon small, regional firms to bring them public and to maintain markets in their securities. From the perspective of a regional firm, the underwriting of and market making in local issues were exceptionally good sources of revenue. One complemented the other. It was the regional firm that actively merchandised and promoted stocks with a local following. Recent acquisitions of regional brokers by national firms with offices located in major financial centers brought about a significant change in the types of stocks recommended by the offices of what once were independent firms. With a national audience, national firms usually spend their research dollars on issues with a national following. Thus much of the sponsorship of smaller issuers has been lost. This development has been the least desirable aspect of the contraction of the broker-dealer community and the increased concentration of business activity into larger firms.

FACTORS CONTRIBUTING TO THE DECLINE IN THE NUMBER OF BROKER-DEALERS

There are of course several factors which have contributed to the decline in both the number of registered broker-dealers and in the number of firms engaged in underwriting activity. Certain of these factors, such as the impact of inflation and the withdrawal of the individual investor, have already been touched upon and discussed in detail elsewhere in this Report. There are, however, other important factors which must also be examined, particularly from the standpoint of the seriousness of their impact on the broker-dealer community. First, accurate forecasting of future developments in the securities industry is made extremely difficult by both the cyclical nature of our economy and the oftentimes erratic behavior of investor demand. Aggregate volume of shares traded and the average price per share is virtually impossible to predict. Because of this inability to determine with any degree of accuracy what the marketplace will be like over a given period of time, broker-dealers frequently find themselves scrambling to add personnel and expand services during periods of peak volume. When interest wanes these firms are forced to take steps to cut costs in order to remain viable. Operations are pared with reductions in both staff and overhead given top priority. Inevitably during these periods of transition, there are a number of firms which for one or more reasons do not respond quickly enough to recover. Still others are pushed toward merger or consolidation with a stronger, more financially sound partner in order to avoid a similar fate. The merger trend has accelerated in recent years particularly because of the precipitous changes which have taken place in business cycles and the increased costs associated with conducting a securites business.

Firms which have fallen victim to the ebb and flow of market activity include those with a relatively inadequate and inexperienced management team, those with an inadequate financial base and those which have not diversified their operations to any extent, but rather have "put all of their eggs in one basket" by limiting their activities to a single product or product line. In recent years, improved examination and surveillance programs by self-regulatory and regulatory organizations, more comprehensive rules regarding financial and operational condition and increased entry standards for new firms have served to reduced substantially the number of broker-dealer failures. Also, the Committee believes that conditions such as substantial increases in overhead brought about by rapid technological change, are likely to occur less suddenly today than they did in the early part of this decade when computerization of the industry took place. These factors lead to the conclusion that while some amount of economic dislocation will always be present in this industry, it will probably occur in the future in a more gradual and more orderly manner.

Another factor contributing to the contraction of the broker-dealer community is the inadequacy in the rate of return. Many firms have simply chosen to terminate business as a broker-dealer because the rate of return was unacceptable and have instead invested their funds and talents in other areas, many of which are totally unrelated to the securities business.

Yet another factor in both the decline in the number of registered broker-dealers and the increase in industry concentration which warranted examination by the Committee was the introduction of fully negotiated commission rates and the simultaneous abolition of standard brokerage fees on May 1, 1975. While studies completed on the impact of the congressionally mandated unfixing of brokerage commissions have produced conflicting findings, the Committee is unanimous in its opinion that a fair amount of contraction in this industry took place as a result of this action. While a federal panel studying anti-trust laws has concluded that" . . . concentration in the securities business has not been seriously increased and competition remains vigorous," [53] Professor Hayes has discovered that ". . . following the institution of negotiated commission rates, virtually every major institutional research firm has disappeared as an independent entity." [54] The Securities Industry Association has also taken issue with the federal panel finding, arguing that its figures show that the market share of the top 25 securities firms, as measured by commission revenues, total revenues and capital, has continued to increase since the advent of unfixed rates. The following SIA table illustrates that argument.

Table 11

Market Share of the Largest 25 Firms

	First Quarter 1973	First Quarter 1975	Third Quarter 1978
Commission Revenues	39.4%	50.6%	64.5%
Total Revenues	45.1%	58.1%	69.7%
Capital	46.6%	58.1%	66.5%

Source: Securities Industry Association.

From the Committee's point of view, while negotiated commissions have benefited certain large investors who are now able to execute securities transactions at rates below those which existed prior to May 1, 1975, they have also served to accelerate the demise of a number of broker-dealers. According to the SIA, the top 25 firms enjoy almost a 70 percent share of total industry revenues. The remaining 30 percent of revenues is divided among almost 3,000 other broker-dealers. Should the revenue share of the 25 largest firms continue to increase, the remaining brokers will be forced to compete for an ever-shrinking portion of the income pie. In the Committee's opinion, such competition can only produce a new wave of mergers and consolidations among firms seeking to retain their capital positions and will accelerate the number of broker-dealers which will either be forced out of the securities business or voluntarily choose to withdraw from the industry rather than continue to see their expenses outpace their revenues by increasingly wider margins.

Another contributor to the decline in the number of broker-dealers in business today, one which will be examined in more detail in a later segment of this Report, is the sharp reduction in corporate financing via the public offering of equity securities. The loss of underwriting revenue generated by primary and secondary stock issues has come at a most inopportune time. As operating costs rise, broker-dealers seeking ways to offset such costs are unable to turn with any success to the equity financing area. Likewise, it has become more difficult for securities firms to raise capital on their own. The drop in the number of corporate underwritings has also signaled a decrease in the probability of success for offerings by broker-dealers of their own securities. Additionally, double digit interest rates have made borrowing an extremely unattractive alternative. Broker-dealers, due to the cyclical nature of their business, are less likely to be considered "preferred risks" by a potential lender and frequently incur higher borrowing rates.

The increase in popularity of company sponsored dividend reinvestment plans, which allow stockholders to buy shares of a company with their dividends instead of accepting them in cash, has adversely affected the flow of funds handled by broker-dealers. Participation in a dividend reinvestment plan, now offered by about 1,000 U.S. corporations, obviates the need for an individual or an institution to employ the services of a broker-dealer to effect a securities purchase. As a result, approximately $2.52 billion is invested annually without the participation of a broker-dealer.[55]

The Committee has also examined the question of the expenses associated with conducting a securities business and has concluded that the increased cost of operation has significantly impacted the ability of broker-dealers, particularly those with a small capital base and a limited clientele, to continue to function as independent entities. Prime contributors to the spiraling costs experienced by securities firms have been the increased disclosure and compliance requirements imposed under today's more complex and more costly scheme of regulation. Additionally, the growing demand for firms to add personnel and equipment to keep up with the regulatory and technical changes taking place in the industry has proven to be very costly.

Broker-dealers today are faced with a myriad of reporting requirements imposed upon them by

[53] Report to the President and Attorney General of the National Commission for the Review of Antitrust Laws and Procedures, January 22, 1979, p. 184.

[54] Hayes, p. 183.

[55] This information is provided as a matter of fact and should not be viewed as a position against dividend reinvestment plans.

both federal and state regulatory agencies and self-regulatory organizations of which they are members. While these requirements are intended to serve essential purposes by monitoring a firm's financial viability, by measuring the qualifications of its personnel engaged in securities trading and by otherwise contributing to the protection of public investors, it must be pointed out that almost every broker-dealer, regardless of its size, is subject to duplicative regulatory oversight. In this connection, the cost of compliance weighs heaviest on those firms with limited resources and staff. There occurs, in the Committee's opinion, a point at which a broker-dealer must choose among absorbing the cost of personnel needed to satisfy his regulatory obligations, assigning some portion of the task to another party by agreement and reimbursing such party for the cost of services performed, or attempting to achieve economies of scale which are thought to be possible through merger with another entity. Each of these courses of action have been followed by many securities firms. The more prevalent of these have been the employment of a clearing firm or service bureau to perform certain recordkeeping functions and a decision in favor of merger or acquisition.

Broker-dealers are able to achieve certain economies in several different ways, e.g., by technological innovation via computer applications, by contracting out certain back office functions through clearing arrangements, and through mergers and acquisitions, among others.

Of the various methods used today to achieve cost savings, it is merger and acquisition that troubles this Committee the most. Whenever mergers and acquisitions occur one thing is certain—there will be fewer independent judgements made as to what stocks will be promoted and merchandised and to whom financial services will be provided. In this connection, the biggest loser appears to be small business which needs an increased level of promotion and sponsorship—not a reduction.

GENERAL CONCLUSIONS

Nothing on the horizon suggests to the Committee that the trend toward consolidation in the securities industry will soon end. As profit margins continue to slide due to rising costs and as the growth rate in industry capital remains at a level which is inadequate to meet demands, mergers and acquisitions are going to continue. Even those smaller firms which remain "independent" will probably do so at the cost of concentrating their activities in lower risk areas since they are less capital-intensive. These areas require the commitment of fewer resources and, therefore, free assets for use in combating rising incremental costs. If such is to be the course of action of many of the more seasoned brokerage firms, certainly individuals contemplating the formation of new securities firms are likely to follow in their footsteps. Under present conditions, the Committee foresees only a nominal increase in the number of new full service brokerage firms entering the industry. Diversification, especially into high-risk areas, will only come with the passage of time as new broker-dealers develop the management expertise and the customer interest which is essential to their continued success. If, however, incentives can be offered, new firms may be encouraged to undertake securities market making and risk underwriting. Only when the risk/reward ratios associated with market making and underwriting perceptibly improve, will there be a tendency for firms to move into those areas.

RECOMMENDATIONS

Although the picture painted for the future of the securities industry depicts a number of serious problem areas, there are several steps that can be taken to reduce a broker-dealer's cost of doing business and to attract much needed broker-dealer capital and its deployment in risk-taking areas.

- **Establishment of a Nationwide Network of Clearing and Settlement Facilities Featuring a Cost Structure Based on Geographic Price-Mutualization**

  One of the steps recommended by this Committee is that the present practice of uniform clearance and settlement charges for processing securities transactions be extended. In the clearing area, three major clearing entities, the National Clearing Corporation, the Stock Clearing Corporation and the American Stock Exchange Clearing Corporation, were recently merged to form the National Securities Clearing Corporation (NSCC). NSCC began a two-phase operation in January, 1977, with its goals being both the establishment of full interfaces with other existing clearing facilities under arrangements by which interface movements would be effected at no charge to participants and the development of a schedule of uniform service charges which would be unaffected by a firm's physical location. This principle of uniform service charges, otherwise known as "geographic price-mutualization," is, in the Committee's opinion, an extremely important concept. It is one remedy for many of the ills which have plagued smaller, regional broker-dealers which have been unable to compete effectively with the larger firms whose proximity to clearing facilities has given them a decided advantage in the ability to reduce the charges associated with the clearance of securities transactions. The Committee therefore recommends that the ongoing efforts to establish a nationwide network of clearing facilities featuring a cost structure based on geographic price-mutualization be continued and given top priority by all parties involved. Together with a nationwide system of clearing facilities should come a nationwide system of settlement facilities under which the need to physically move securities from one location to another would be eliminated. The Committee recommends that the SEC and various institutions cooperate in an effort to develop a nationwide system which provides for book entry settlement. Such a system would serve not only to achieve one of the goals of the 1975 Securities Acts Amendments by immobilizing the stock certificate but it would also reduce the very substantial interest costs which broker-dealers are forced to pay under the operation of the present settlement system.

- **Continuation of Current Efforts to Reduce the Cost of Broker-Dealer Regulation and Compliance**

  Regulatory agencies have also begun to realize the impact that their various reporting and compliance requirements have had on the costs associated with operating a securities firm and have taken steps recently to simplify and standardize these procedures. Uniform rules in the net capital and customer protection areas, the simplification and streamlining of industry arbitration procedures and the creation of standard reporting forms are a few examples of the developments which have taken place in recent years to lessen the complexities associated with being a broker-dealer and complying with the minimum requirements to which a firm is subject. Further, self-regulatory organizations have moved to eliminate duplication in areas involving members which they have in common. Particularly pertinent in this connection has been SEC approval of agreements among certain self-regulators providing for the allocation of certain regulatory functions for a number of firms to a single organization. As a result of these agreements, overall compliance-related expenses of self-regulators have been reduced. The benefits of such cost savings will ultimately be realized by the broker-dealers whose assessments contribute to the support of these organizations.

  A further step can, however, be taken in this area. As most are aware, the existing scheme of self-regulation remains fragmented in that there are a number of self-regulatory organizations with duplicative overhead costs and programs which the industry, particularly dual members of these various organizations, is called upon to support. In the Committee's opinion, the establishment of a single self-regulatory organization for the industry would result in substantial savings. From a public interest perspective, it would also bring about improvement in the quality, uniformity and comprehensiveness of broker-dealer examinations and inspections. The Committee therefore recommends that the industry, together with appropriate SEC oversight, take steps to develop and thereafter implement this concept.

- **Establish Special Tax-Deferred Reserves for the Securities Industry**

  The Committee also finds it appropriate to restate in this section of its Report its recommendation calling for the establishment of special reserves for securities trading. The relevance that such a proposal has to reducing the concentration in and contraction of the broker-dealer community rests with the impetus which it would give to firms to expand and diversify their operations to include market making activities and perhaps underwriting. Such expansion and diversification would broaden the revenue base of securities dealers and enable them to cope with the demands placed on their business by substantial operational and compliance costs. Also, by making such reserves non-transferable the incentive to merge would be decreased.

63-769 O - 80 - 20

CHAPTER SEVEN

IMPACT OF CURRENT TAX LAWS ON SMALL BUSINESS AND INVESTORS

This section of the Report examines the impact of the current tax code on small business and it discusses the Committee's suggested changes for amending the Code to encourage and stimulate investment in these developing companies. Notwithstanding the fact that the American economy has experienced a sustained period of growth during the 1970's, the rate of investment in fixed assets, so vital to sustained economic growth, has been distressingly low. Indicative of this lag is the fact that while the gross national product in 1978 increased tenfold to $2,212.1 billion from $232.8 billion in 1947, new plant and equipment expenditures during the same period registered only a sevenfold increase from $19.3 billion to $153 billion.[56]

Recent statistics indicate a trend toward an increase in capital investment. According to Commerce Department statistics, in 1978, new plant and equipment expenditures exceeded those made in 1977 by $17 billion.[57] However, according to one leading economist, this increase in expenditures was directed primarily at improving the productivity of existing facilities and was of little benefit to the capital starved small business sector which is of such vital importance to the American free enterprise system.[58]

LACK OF ADEQUATE TAX INCENTIVES HAS DISCOURAGED INVESTMENT IN SMALL BUSINESS BY BOTH INDIVIDUAL AND INSTITUTIONAL INVESTORS

The sharp cutback in small business investment initiative has many causes. Of all that have been identified, the two that generally find their way to the top of everyone's list are corporate income taxes and taxes on capital gains. Also, Code requirements which restrict the sources of small business investment for Subchapter S companies and those which hamper the ability of small business to attract management talent and to compensate key personnel are also frequently mentioned as major problem areas. It is the contention of this Committee that the lack of adequate tax incentives has both discouraged and, in some cases, prevented investment in small business by both individual and institutional investors.

TAX POLICY LIMITS SMALL BUSINESS ACCESS TO PUBLIC SECURITIES MARKETS

One result of tax structure disincentives is the very limited access of small businesses to public securities markets and the subsequent over-reliance on short and long term debt for financing innovation, modernization and expansion. As noted in Chapter Two, an SBA Task Force Study found that businesses normally do not attain access to the public securities markets until they generate annual revenue in excess of $10 million. Normally, this does not occur until after the enterprise has been a going concern for five to fifteen years.[59] In addition, the study found that it is not until annual revenues of developing companies reach $25 to $40 million that the entire spectrum of financing sources, to a greater or lesser extent, becomes available to them.[60]

Because of the time lag between start-up of an enterprise and the point in time in its development when it has access to the public markets, small businesses must rely on the personal capital of the owner(s), as well as individual investment via partnership arrangements or private placements. Capital is also available at this stage through personal or corporate loans from commercial banks.[61] The major drawback to this source of funds, however, is the non-permanent nature of the investment. Another adverse effect of borrowing is the impact of these borrowed funds on the equity/debt ratios as demonstrated in Chart 3.[62] The value of this ratio is that it functions as an important indicator of the credit worthiness of a corporate enterprise. The higher the ratio, the greater the creditor's margin or protection and the more manageable the company's debt is likely to be.[63]

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[56] *Survey of Current Business*, pp. S-1, S-2, *1977 Business Statistics*, pp. 1, 12.

[57] *Survey of Current Business*, p S-2

[58] Michael J. Kami, *External Factors Assumptions for Planning Business Strategies 1979*, Corporate Planning, Inc., Lighthouse Point, Florida, October, 1978, p Fin-6.

[59] *Report of the SBA Task Force on Venture and Equity Capital for Small Business*, U S Small Business Administration, Washington, January, 1977, pp 4–7.

[60] Ibid.

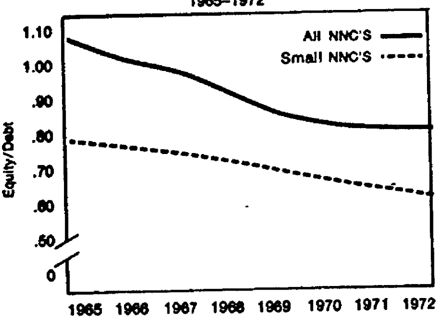
[61] Ibid

[62] *The Financing of Small Business Corporations*, U S Small Business Administration, Washington, October, 1978, p 54

[63] Ibid., p 13

CHART 3

Equity/Debt Ratios,
Small vs. All Nonfinancial, Nonfarm Corporations
1965–1972



Source: Small Business Administration.

This trend is also apparent in the Federal Trade Commission's figures for manufacturing corporations. In the fourth quarter of 1968, total liabilities for all manufacturing corporations comprised 43.8 percent of the balance sheet total while stockholders' equity accounted for a healthy 56.2 percent. For corporations with under $5 million in assets, the total liabilities were slightly lower at 43.2 percent of the balance sheet total and stockholders' equity stood at 56.8 percent. However, by the end of the fourth quarter of 1978, total liabilities for all manufacturing corporations were up 4.4 percent to 48.2 percent while stockholders equity dropped a corresponding amount to 51.8 percent. For the smaller corporations (those with assets under $5 million), the numbers were even more dramatic with fully 55.1 percent of the balance sheet representing liabilities and only 44.9 percent comprising stockholders' equity—a shift of 12 percent during the intervening years.

Although the trend to lower equity/debt ratios appears to be across the board for the whole economy, the smaller firms who have yet to gain access to the normal capital markets are the hardest hit. Traditionally, their available sources of capital are borrowings or earnings and as their equity/debt ratios decrease, borrowing becomes increasingly more difficult. Thus, they are forced to rely on earnings as their principal source of investment capital. For a developing company, however, earnings are usually inadequate to provide the financing required for above-average growth.

The limited access of developing companies to the public securities market results in increased reliance on federal assistance via equity financing through small business investment companies (SBIC's). SBIC's are privately owned and privately governed entities which are licensed by the Small Business Administration to serve as conduits for the federal government in providing equity capital and long-term loans to smaller companies. In calendar year 1973, SBIC's provided financing to 2,121 businesses in the amount of $193 million while in calendar year 1978, SBIC's were involved in 2,550 such financings at an aggregate cost of $265 million.[14] While the 1978 amount represents a 37 percent increase over 1973 levels, the totals are relatively insignificant in relation to the needs of small business.

GENERAL CONCLUSIONS

In the Committee's opinion, the capital raising problems faced by small business can be remedied, in part, through reforms in the tax code. The judicious application of reforms would go a long way toward reversing this clearly unhealthy economic atmosphere. It is unacceptable to this Committee that one of the principal assets of this country, small business, is losing the battle to obtain the sponsorship needed to secure appropriate financing. This Committee sincerely believes that if appropriate steps are not taken to promote private investment in small business, their only recourse will be to seek funds from either large institutions which, as indicated earlier, have not as yet demonstrated an inclination to invest appreciable amounts in small business, or the government, which could bring this nation one step closer to the end of the private free enterprise system as we now know it. In that connection, the Committee recommends several actions regarding the Code which it believes will help to ameliorate the problems encountered by small business in its never-ending search for capital.

RECOMMENDATIONS

- **Effect a Further Reduction in the Capital Gains Tax Rate**

  As noted in an earlier section, the Committee favors a further reduction in capital gains tax rates. The recent reduction in the capital gains tax rate is laudable but financing for small businesses would be encouraged further if the tax rate for gains in equity investments in such businesses were further reduced. It is recommended, therefore, that the amount of long-term capital gains excluded from taxable income be increased to 80 per-

[14] Data supplied by U. S. Small Business Administration.

cent of the gains realized from the sale or exchange of investments in businesses which had no more than $5 million of equity capital at the time such investments were made. As an alternative to an across-the-board capital gains tax reduction for small business investment, the Committee would support a capital gains exclusion computed on a sliding scale, ranging from 80 percent down to 60 percent, depending on the size of the small business, as of the date that the investments which produce the capital gains are made. This alternative is a less desirable proposal since it is more complicated and, thus, more difficult to understand and to administer.

- **Allow Investors to Defer Tax on Gains in Small Business**

Legislation recently introduced in the Senate by Senators Nelson, Baucus, Weicker and Huddleston would permit anyone owning an interest in a small company with a net worth of $25 million or less to sell that interest for cash, reinvest the proceeds in another small business and defer the capital gains tax on the sale until such time as the proceeds are taken out of the small business and not reinvested within an 18-month period. This Committee supports that proposal as do apparently 147 respondents to the Committee's survey.

Under existing law, an investor who sells his equity interest in a small business for more than it cost him realizes a taxable capital gain, provided that his investment is a capital asset. Frequently, an investor in such circumstances prefers to retain the investment or to dispose of it in a non-taxable transaction, such as a merger, rather than incur the tax liability. In either event, he will not realize cash which he can reinvest in new ventures. Even if he sells his investment, the tax on his capital gain—unless he has offsetting capital losses—will reduce the money he will have available for the support of other small businesses. In order to free the full amount of gains achieved in successful ventures for reinvestment in other small businesses, the Committee agrees that investors should be permitted to roll-over such gains in new investments in small businesses by deferring the tax liability until such time as the funds are no longer devoted to the support of such entities. This concept is comparable to the treatment afforded homeowners on the sale of a residence.

- **Consider a Further Graduation of the Corporate Tax Structure**

The Committee also recommends that the income tax rates for Corporations be further graduated to enable smaller firms to retain a greater proportion of their earnings to finance expansion and capital improvements. Although some measure of relief was provided by congressional adoption of reduced corporate income tax rates in the Revenue Act of 1978, the Committee believes that a further reduction in the rates and expansion of the income brackets would greatly benefit the economy. The Committee's recommendation is based on the knowledge that the viability of small business is critical if our economic system is to realize its full potential. When one considers the immense benefits that flow from our small businesses it is only reasonable that they be permitted to retain as much of their before tax revenues as possible in order to perform their job creating and resource allocating functions as effectively as possible. The Committee firmly believes that this effectiveness can be significantly improved by congressional action designed to enhance the progressive nature of the corporate tax structure thereby enabling a vital and well-financed small business sector to provide the nation and its people with even greater benefits. In the opinion of this Committee, adoption of the proposal will have a positive impact on the nation's economy and, in due course, will result in tax receipts which will more than offset the initial net loss to the Treasury.

- **Increase to 35 the Allowable Number of Shareholders of Subchapter S Corporations**

Under existing tax law, a small business corporation electing to be taxed under Subchapter S (Sections 1371-1377) of the Internal Revenue Code must have 15 or fewer shareholders. Since our inflationary economy necessitates increasing amounts of capital investment for the profitable operation of a small business concern, these existing limitations have an adverse impact on the growth of small business corporations. The shareholder limitations hinder business growth and planning by requiring the investment burden and risk to be spread among a small number of shareholders. Furthermore, Subchapter S treatment is not available to corporations which have any shareholder who is not an individual and which have more than one class of stock. The former restriction prevents investment by institutional investors, and the latter restriction inhibits investment by persons who may desire special rights as shareholders in return for risking their investment capital.

In order to lessen the burden on individual shareholders and to encourage investment in Subchapter S corporations, the Committee recommends that the limitation on the number of shareholders of Subchapter S corporations be increased to 35 and that the limitations on the type of shareholders and the classes of stock be removed. The proposed increase to 35 shareholders would coincide with the exemption criteria contained in Rule 146 under the 1933 Act as such relates to the maximum number of purchasers. If this proposal were adopted, a small corporation would have a much more reasonable opportunity to obtain capital without destroying the availability of the Subchapter S election.

- **Eliminate the Provisions of the Code That are Applicable to Qualified Retirement Plans of Subchapter S Corporations Only**

  Under existing law, special Internal Revenue Code provisions are applicable to the qualified retirement plans maintained by Subchapter S corporations which are not applicable to plans of other types of corporations. For example, the Code provides that if a contribution in excess of the lesser of $7,500 or 15 percent of compensation is made to a retirement plan on behalf of a shareholder owning more than five percent of the stock of a Subchapter S corporation, such excess would be income to the shareholder. As a practical matter, this provision constitutes a limitation on the benefits provided under retirement plans of Subchapter S corporations.

- **Tax the Increase in Value Between Grant Price and Sale Price of Securities Acquired Through the Exercise of Stock Options From Small Businesses as a Long Term Capital Gain at the Time the Securities so Acquired are Sold**

  Small businesses may be better able to attract new talent if they are able to give key personnel an interest in the business by means of stock options. A benefit such as this is crucial to small businesses since they cannot compete with large corporations in terms of salaries and other benefits. For all intents and purposes, small business is precluded from using this method of compensation today since the Code currently taxes the employee recipient at the ordinary income tax rate at the time he exercises his option on a gain has not as yet realized. In effect, he is called upon to put up money in order to pay taxes on gains that are no more than unrealized paper profits.

  Since the valuation of the stock, or an option to acquire stock, in a closely-held business is one of the most difficult practical problems under the tax laws, the existing tax treatment of stock options does not adequately meet the needs of new businesses to attract key personnel. For example, there is the possibility of a costly dispute with the Internal Revenue Service over the correct valuation of the option. Moreover, even if an ascertainable fair market value is established for the option, the employee will be taxed at the time he receives the option although he has not yet realized any cash therefrom and does not have a public market in which to sell. If the option is never exercised, the employee will simply incur a capital loss. Furthermore, if tax at ordinary income tax rates is levied when the option is exercised, illiquidity of the stock received in a small corporation may be a serious problem. It may mean that tha employee will have to obtain funds from other sources in order to be able to pay the income tax. Accordingly, for stock options granted to employees by small businesses with less than $25 million in equity, it is recommended by this Committee that the Code be amended to provide that no gain will be recognized by such employees at the time stock options are granted or exercised and that the gain on securities acquired via the exercise of a stock option be the excess of the sale price of the securities over their value at the time of grant and, further, that such gain be recognized as a long-term gain if the combined holding period for the option and the stock is not less than three years.

- **Permit Three Year Accelerated Depreciation For Purchases of Machinery and Equipment Having a Useful Life of 36 Months or More Up to a Maximum of $100,000 Per Year**

  On January 23, 1979, Senators Nelson, Ford, Huddleston, Pell, Sasser, Weicker and Stewart introduced a bill to amend the Code to provide accelerated and simplified depreciation allowances for small businesses. The bill would allow tax deductions for the full amount of machinery and equipment purchased—up to a limit of $25,000 per year—over a three-year period, rather than the 10½ years which is the average under current law. With current inflation rates, however, the amount of money recovered from depreciation during the tenth year will be worth about 20 percent of what was invested and the equipment that must be purchased as a replacement will cost about 80 percent more. This, coupled with the finding that approximately 80 percent of all businesses purchasing equipment in any one year spend less than $250,000, was the genesis of S. 110.

This Committee supports congressional efforts to adopt an accelerated depreciation allowance for small business. It agrees with Federal Reserve Board Chairman William Miller that accelerated depreciation is a very efficient way to encourage capital investment. The Committee believes, however, that the $25,000 limitation is too restrictive, particularly in these inflationary times. It believes that $100,000, the amount originally proposed in S. 2742 [95th Cong., 2d Sess. (1978)] is a more fitting level since it is not based on what purchases of machinery have been, but rather, what they could be.

- **Revised Criteria to Obtain a Tax Credit For Contributions to an ESOP**

In recent years, Congress has made changes in the Code designed to encourage the establishment of employee stock ownership plans. One of the most significant of such changes was the allowance of an additional investment tax credit for contributions to an employee stock ownership plan. The amount of the allowable credit is related to the amount of the employer's investment that qualifies for investment tax credit purposes. As a result, the credit, in practice, is available only to companies with significant investments in depreciable property. Small corporations ordinarily are not in a position to take advantage of this credit. In order to encourage small corporations to establish employee stock ownership plans, it is recommended that the tax credit for contributions to such plans not be tied exclusively to the investment tax credit, but that an employer be permitted to elect instead to take a tax credit for contributions of up to 2 percent of the compensation of the participating employees.

CHAPTER EIGHT

AVAILABILITY OF EQUITY FINANCING FOR SMALL BUSINESS

BACKGROUND

One of the most talked about phenomena in the securities industry has been the unabated decline in the number of new issues brought to the marketplace during the past few years. The precipitous drop in new stock issues publicly offered is graphically illustrated in the following table.

Table 12

Common Stock Offerings For Which There Was No Prior Market (New Issues)

Year	No. of Issues	Share Value ($ Millions)
1968	849	1,742
1969	1,298	3,545
1970	566	1,451
1971	446	1,917
1972	646	3,301
1973	177	1,872
1974	55	117
1975	29	272
1976	45	271
1977	49	276
1978	58	214

Source: *Investment Dealers' Digest.*

As indicated, the aggregate number of common stock offerings for which there was no prior public market made during the period 1973 through 1978, was less than two-thirds of the number of such offerings brought to market in 1972 alone. The most dramatic percentage declines in new offerings came in 1973 when total issues fell 73 percent from the number offered in the previous year and in 1974, when there was a drop of 69 percent from the 1973 figure. The value of shares offered publicly declined from $3,301 million to $117 million in that same two-year period representing a decrease of a staggering 97 percent in the amount of funds raised by first time issuers of securities.

Looking beyond the total number of new issue offerings in each of the past eleven years and into specific registration areas, the Committee discovered an even clearer pattern of decline in certain types of new financings. As indicated in Table 13, offerings of less than $5 million by first time to market issuers making use of SEC Form S-1 fell 65, 67 and 50 percent in 1973, 1974 and 1975, respectively. At year end 1976, the number of such offerings made during that year equalled only six percent of the number of such offerings made in 1972.

In the Committee's opinion, there are a number of reasons for the dismal performance of the new issues market. To begin with, the stock market as a whole has experienced its share of problems during the past few years. Riding a crest of investor interest and demand, the market peaked in January, 1973, as the Dow Jones Industrial Aver-

Table 13

New Issue Offerings Using SEC Form S-1
1971-1976

	Offerings Not in Excess of $3 Million by First Time Issuers on Form S-1		Offerings Greater Than $3 Million But Not in Excess of $5 Million by First Time Issuers on Form S-1		Offerings Not in Excess of $5 Million by First Time Issuers on Form S-1	
	Number of Offerings	Total Dollar Value Offered ($ Millions)	Number of Offerings	Total Dollar Value Offered ($ Millions)	Number of Offerings	Total Dollar Value Offered ($ Millions)
1971	258	349.6	38	147.8	296	497.4
1972	347	532.9	104	406.0	451	938.9
1973	131	162.8	28	110.3	159	273.1
1974	43	53.6	9	33.9	52	87.5
1975	24	30.9	2	9.3	26	40.2
1976	22	31.6	6	24.3	28	55.9
TOTAL	825	1,161.4	187	731.6	1,012	1,893.0

Source: Securities and Exchange Commission.

age hit a record 1,051. The subsequent oil embargo, the advent of double-digit inflation and increased economic uncertainty took their toll on stocks in the months that followed, creating a wave of selling which plunged prices and drove countless numbers of investors from the marketplace. As discussed earlier in this Report, inflation and related economic problems continue to hamper the return of investors to the stock market. A renewal of general investor confidence in equities is needed before common stock offerings can regain their past prominence as a viable method of financing. Not coincidentally, the peak year for most stock market indices (1972) was also the last really significant year in terms of the number and value of new stock offerings. The number of new issue offerings has generally declined since that time. Of interest is the fact that notwithstanding a general recovery in the equity markets since 1974, no similar recovery has occurred in the new issue market. In large measure, this can be attributed to the contraction which has taken place in the securities industry, the institutionalization of markets, escalating costs which have created barriers to public financing, overall economic conditions and the advent of listed options and the promotion of other speculative vehicles. As noted, to some degree the new issue market has been afflicted by the emergence of new investment vehicles but none so great as the listed options markets. As most are aware, the Chicago Board Options Exchange (CBOE) opened in April, 1973, as the nation's first national exchange on which option contracts were traded. From modest beginnings which saw volume total 2.9 million contracts in the first full year of operations, CBOE activity increased to the point where in fiscal 1978, almost 29 million contracts were traded.[15] The CBOE's success prompted other exchanges to develop options trading programs of their own. Today options are also listed on the American, Midwest, Pacific and Philadelphia Stock Exchanges. Together with the CBOE, these exchanges generated volume of 47.4 million contracts during fiscal 1978, a figure which represents a 5,000 percent increase in listed options trading since its inaugural year.[16]

Quite clearly, the emergence of the listed options marketplace and the success it has enjoyed has negatively affected the flow of funds to the new issues market. In addition, growing investor interest in commodities and the financial futures markets has further drained the supply of new issues market funds.

[15] (1978) *CBOE Ann. Rep.*, p. 7

[16] *Options Clearing Corporation Newsletter*, Vol. I, No. 14, p. 2, Options Clearing Corporation, Chicago, August/September, 1978

Several other factors are also responsible for the decline of the new issues market. Among these has been a steady increase in the amounts of funds flowing out of equities and into the government securities and the fixed income markets (see Chart 3, page 33). While this analysis was used to demonstrate the withdrawal of the individual investor from the equities marketplace, it is also relevant to the discussion of the vanishing new issues market. The diversion of funds to high yield, fixed income securities has naturally meant that fewer monies are available for general equities investment and fewer still for investment in "first time to market" companies. The increased level of investment in debt securities is a reflection of increased demand for funds by all levels of government and the private sector. This increased demand has precipitated tremendous competition for funds which, in turn has pushed interest rates and corresponding investor yield to all-time highs. Corporate issuers have also turned to debt as a means of raising capital since an issuer's ability to obtain debt financing is, for the most part, limited primarily only by the interest rate it is willing to pay. New offerings of equities securities, however, must be priced in reasonable relation to earnings, both actual and projected. Hence, there is less flexibility in pricing an issue of equity. Also, debt service can, of course, be expensed while dividend payments on stocks are dealt a double blow with taxes on such having to be borne by both the corporate issuer and the shareholder recipient.

The loss of a number of underwriting firms through merger, liquidation and consolidation has, in no small measure, also adversely affected the new issues market. As discussed earlier in this report, fewer broker-dealers in business today means there are fewer underwriters seeking new companies to bring to market and fewer opportunities available to investors willing to participate in first time to market ventures. It appears that the problem of a contracting securities industry compounded by the flight of individual investors from the marketplace has narrowed the avenues of investment opportunity available to public investors.

A Morgan Stanley prepared, marked-up version of a tombstone advertisement for a General Motors offering which took place in February, 1955, visually depicts what has happened to the underwriting business in the last 25 years. The tombstone ad which appears on pages 39 to 43 of this Report identifies by color code the underwriting firms no longer in business. Not only are these firms no longer in business, but no new firms have stepped forward to fill the void their departure has created.

The segment of underwriters hardest hit were, Prior to 2 9 70 [redacted]

2 9 70 to 2 9 75 [redacted]

2 9 75 to 10 24 77

10 24 77 to Present or Pending

This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these Shares The offer is made only by the Prospectus

4,380,683 Shares

General Motors Corporation

Common Stock

$5 Par Value

Rights, evidenced by subscription warrants to subscribe for these shares are being issued by the Corporation to the holders of its Common Stock, which rights will expire at 6:00 P.M. Eastern Standard Time, on March 7, 1955, as more fully set forth in the Prospectus

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Subscription Price $75 a Share

The several underwriters may offer shares of Common Stock at prices not less than the Subscription Price set forth above less, in the case of sales to dealers, the concession allowed to dealers and not more than either the last sale or current offering price on the New York Stock Exchange, whichever is greater, plus an amount equal to the applicable New York Stock Exchange Commission.

Copies of the Prospectus are obtainable from the undersigned

MORGAN STANLEY & CO.

DILLON, READ & CO. INC. THE FIRST BOSTON CORPORATION KUHN, LOEB & CO.

BLYTH & CO., INC. GOLDMAN, SACHS & CO. [redacted]

KIDDER, PEABODY & CO. LAZARD FRERES & CO. LEHMAN BROTHERS

MERRILL LYNCH, PIERCE, FENNER & BEANE SMITH, BARNEY & CO.

[redacted] [redacted]

WHITE, WELD & CO. DREXEL & CO. HORNBLOWER & WEEKS

PAINE, WEBBER, JACKSON & CURTIS SALOMON BROS. & HUTZLER

WERTHEIM & CO. DEAN WITTER & CO. [redacted]

DOMINICK & DOMINICK [redacted]

[redacted] [redacted]

[redacted] CARL M. LOEB, RHOADES & CO. F. S. MOSELEY & CO.

L. F. ROTHSCHILD & CO. [redacted] [redacted]

[redacted] R. W. PRESSPRICH & CO. REYNOLDS & CO.

SPENCER TRASK & CO. TUCKER, ANTHONY & CO. [redacted]

February 9, 1955.

Clauses and Imprints for

General Motors Corporation

Common Stock

STANDARD CLAUSE

This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these Shares. The offer is made only by the Prospectus.

Copies of the Prospectus are obtainable from the undersigned.

CLAUSE A

This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these Shares. The offer is made only by the Prospectus. This is published on behalf of only those of the undersigned who are registered dealers in securities in this State.

Copies of the Prospectus are obtainable from only such of the undersigned as are registered dealers in securities in this State.

MARYLAND CLAUSE

This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these Shares. The offer is made only by the Prospectus. This is published on behalf of only those of the undersigned who are registered dealers in securities in this State, or are firms a partner of which is a member of a national securities exchange registered with the Securities and Exchange Commission under the Securities Exchange Act of 193[illegible].

Copies of the Prospectus are obtainable from only such of the undersigned as are registered dealers in securities in this State, or are firms a partner of which is a member of a national securities exchange registered with the Securities and Exchange Commission under the Securities Exchange Act of 193[illegible].

MAGAZINE CLAUSE

This announcement is neither an offer to sell nor a solicitation of an offer to buy any of these Shares. The offer is made only by the Prospectus.

Copies of the Prospectus may be obtained from only such of the undersigned as may legally offer these Shares in compliance with the securities laws of the respective States.

ONTARIO CLAUSE

This advertisement is for informational purposes only and is not to be construed as a public offering in the Province of Ontario.

No Lower Clause

NATIONAL IMPRINT

Albany Anderson Bay City Bedford [illegible] Defiance Des Moines [illegible] Fort Worth Framingham Hamilton Janesville Kansas City Kan. [illegible] Lockport [illegible] New Brunswick North Tonawanda Oakland [illegible] Portland Ore. Saginaw Sandusky Tarrytown Toledo Trenton Warren and [illegible]

MORGAN STANLEY & CO.

DILLON, READ & CO. INC. *THE FIRST BOSTON CORPORATION* *KUHN, LOEB & CO.*

BLYTH & CO., INC. *GOLDMAN, SACHS & CO.* [redacted]

KIDDER, PEABODY & CO. *LAZARD FRERES & CO.* *LEHMAN BROTHERS*

MERRILL LYNCH, PIERCE, FENNER & BEANE *SMITH, BARNEY & CO.*

[redacted]

WHITE, WELD & CO. *DREXEL & CO.* *HORNBLOWER & WEEKS*

PAINE, WEBBER, JACKSON & CURTIS *SALOMON BROS. & HUTZLER*

WERTHEIM & CO. *DEAN WITTER & CO.*

LOCAL IMPRINTS

Use National Imprint and Add:

ALABAMA—Birmingham

STERNE, AGEE & LEACH

[redacted]

CALIFORNIA—Los Angeles

[redacted]

BATEMAN, EICHLER & CO. *CROWELL, WEEDON & CO.* [redacted]

[redacted] *STERN, FRANK, MEYER & FOX*

WAGENSELLER & DURST, INC.

San Francisco

[redacted]

[illegible] [redacted] [redacted]

MITCHUM, JONES & TEMPLETON *SUTRO & CO.* [redacted]

[redacted] *DAVIS, SKAGGS & CO.*

40 [redacted]

[illegible] *WULFF, HANSEN & CO.*

General Motors Corporation

[redacted]

[redacted] [redacted] SHUMAN, AGNEW & CO.

[redacted] [redacted] FOSTER & MARSHALL

MITCHUM, JONES & TEMPLETON SUTRO & CO. [redacted]

BATEMAN, EICHLER & CO. CROWELL, WEEDON & CO.

STERN, FRANK, MEYER & FOX

[redacted]

[redacted] DAVIS, SKAGGS & CO. [redacted]

[redacted] WAGENSELLER & DURST, INC. [redacted]

[redacted] J. S. STRAUSS & CO. WULFF, HANSEN & CO.

COLORADO—Denver

BOETTCHER AND COMPANY

BOSWORTH, SULLIVAN & COMPANY, INC. [redacted]

CONNECTICUT—Hartford

[redacted]

[redacted] [redacted]

DELAWARE—Wilmington

[redacted]

[redacted] [redacted]

DISTRICT OF COLUMBIA—Washington

FOLGER, NOLAN-W. B. HIBBS & CO., INC.

[redacted] JOHNSTON, LEMON & CO. [redacted]

FERRIS & COMPANY [redacted]

ROBINSON AND LUKENS [redacted]

FLORIDA—Jacksonville

[redacted]

GEORGIA—Atlanta

[redacted]

THE ROBINSON-HUMPHREY COMPANY, INC. JOHNSON, LANE, SPACE AND CO., INC.

[redacted] NORRIS & HIRSHBERG, INC.

ILLINOIS—Chicago

[redacted]

A. G. BECKER & CO. [redacted] BACON, WHIPPLE & CO.

WILLIAM BLAIR & COMPANY BLUNT ELLIS & SIMMONS THE ILLINOIS COMPANY

JULIEN COLLINS & COMPANY [redacted] McCORMICK & CO.

RODMAN & RENSHAW [redacted]

MULLANEY, WELLS & COMPANY [redacted]

[redacted] HICKEY & CO., INC.

[redacted]

INDIANA—Indianapolis

[redacted]

RAFFENSPERGER, HUGHES & CO.

KENTUCKY—Louisville

J. J. B. HILLIARD & SON

ALMSTEDT BROTHERS [redacted]

LOUISIANA—New Orleans

HOWARD, WEIL, LABOUISSE, FRIEDRICHS AND COMPANY

MARYLAND—Baltimore

ALEX. BROWN & SONS

[redacted] BAKER, WATTS & CO. JOHN C. LEGG & COMPANY

[redacted] [redacted]

General Motors Corporation

MASSACHUSETTS—Boston

[redacted]

H. C. WAINWRIGHT & CO. [redacted]

MICHIGAN—Detroit

FIRST OF MICHIGAN CORPORATION

WATLING, LERCHEN & CO.

WM. C. RONEY & CO

[redacted]

MANLEY, BENNETT & CO [redacted] SMITH, HAGUE, NOBLE & CO

BAUMAN, McFAWN & CO. [redacted]

Grand Rapids

MacNAUGHTON-GREENAWALT & CO.

Kalamazoo

[redacted]

Lansing

DONOVAN, GILBERT & CO.

MINNESOTA—Minneapolis—St. Paul

PIPER, JAFFRAY & HOPWOOD

[redacted] J. M. DAIN & COMPANY [redacted]

ALLISON-WILLIAMS COMPANY

C. S. ASHMUN COMPANY CALDWELL, PHILLIPS CO. [redacted]

MISSOURI—Kansas City

STERN BROTHERS & CO

[redacted] H. O. PEET & CO.

St. Louis

REINHOLDT & GARDNER

NEWHARD, COOK & CO

STIFEL, NICOLAUS & COMPANY

[redacted] I. M. SIMON & CO SMITH MOORE & CO

STIX & CO A. G. EDWARDS & SONS EDWARD D. JONES & CO

[redacted]

NEBRASKA—Omaha

KIRKPATRICK-PETTIS COMPANY

CHILES-SCHUTZ COMPANY

NEW JERSEY—Newark—N. Y. C. (Jersey City)

[redacted]

LEE W. CARROLL & CO.

NEW YORK—Buffalo

[redacted]

HAROLD C. BROWN & CO., INC

[redacted]

Rochester

[redacted]

LITTLE & HOPKINS

Syracuse

[redacted]

OHIO—Cincinnati

W. D. GRADISON & CO

SEASONGOOD & MAYER

Cleveland

McDONALD & COMPANY

[redacted] FULTON, REID & CO.

PRESCOTT, SHEPARD & CO., INC.

[redacted]

JOSEPH, MELLEN & MILLER, INC. FIELD, RICHARDS & CO

[redacted]

WM. J. MERICKA & CO., INC. J. A. OVERTON & CO.

General Motors Corporation

Columbus

THE OHIO COMPANY

SWENEY, CARTWRIGHT & CO.

Dayton

[redacted]

PENNSYLVANIA—Philadelphia

[redacted] W. H. NEWBOLD'S SON & CO. YARNALL, BIDDLE & CO.

JANNEY & CO. ELKINS, MORRIS & CO. [redacted]

BUTCHER & SHERRERD

C. C. COLLINGS AND COMPANY, INC. DeHAVEN & TOWNSEND, CROUTER & BODINE

[redacted] PARRISH & CO.

BOENNING & CO. [redacted]

Pittsburgh

MOORE, LEONARD & LYNCH

[redacted] A. E. MASTEN & COMPANY [redacted]

THOMAS & COMPANY [redacted] ARTHURS, LESTRANGE & CO.

[redacted] HULME, APPLEGATE & HUMPHREY, INC.

[redacted]

CUNNINGHAM, SCHMERTZ & CO., INC.

RHODE ISLAND—Providence

BROWN, LISLE & MARSHALL

MILLER & GEORGE

TENNESSEE—Nashville

J. C. BRADFORD & CO

[redacted]

TEXAS—Dallas

FIRST SOUTHWEST COMPANY

RAUSCHER, PIERCE & CO [redacted]

The Wall Street Journal

FIRST SOUTHWEST COMPANY

RAUSCHER, PIERCE & CO. ROTAN, MOSLE AND CO

UNDERWOOD, NEUHAUS & CO [redacted]

Houston

ROTAN, MOSLE AND CO.

UNDERWOOD, NEUHAUS & CO [redacted]

UTAH—Salt Lake City

[redacted]

VIRGINIA—Richmond

SCOTT & STRINGFELLOW

[redacted] ANDERSON & STRUDWICK BRANCH, CABELL & CO.

DAVENPORT & CO. J. C. WHEAT & CO.

WASHINGTON—Seattle

[redacted]

FOSTER & MARSHALL

WISCONSIN—Milwaukee

ROBERT W. BAIRD & CO.,

THE MILWAUKEE COMPANY LOEWI & CO.

CANADA—Toronto

A. E. AMES & CO.

THE DOMINION SECURITIES CORPORATION [redacted]

WOOD, GUNDY & CO., INC. McLEOD, YOUNG, WEIR BURNS BROS. & DENTON, INC.

MILLS, SPENCE & CO., INC. [redacted]

as indicated earlier, the second tier or sub-major group. These are the firms recorded by state under the caption "Local Imprints." It is this category of firm that has traditionally functioned as the underwriter of smaller companies.

Contributing to the decline in the number of new issues coming to market has been the escalation of the fixed costs associated with new offerings. While the generally adverse impact of economic uncertainty and inflation on the attitudes of investors has been discussed and the ability of broker-dealers to continue to provide a broad range of investment services examined, the implications of rising fees for legal, accounting and printing services among others, also warrant specific attention. Such costs bear directly on the price which must be paid by companies wishing to enter the equities market and are an important element in the underwriting equation. The Committee fully believes that escalating registration costs have diminished the enthusiasm of issuers, particularly small companies, for new equity financings. With rising costs, the "break even" point or the point at which a company realizes a net return from its venture into new issue financing, creeps ever so higher, putting such beyond the amount many new firms could realistically expect to raise in the marketplace. Such is true even in the case of an offering made pursuant to the provisions of Regulation A of the Securities Act of 1933, which permits issuers, in certain cases, to use unaudited financial statements and less extensive narrative disclosure than that required in a full registration. With the amount of money which could be raised under a Regulation A offering limited until only recently to $500,000, every dollar increase in offering expenses was especially punitive. Issuers could not count on increasing the size of their offering beyond $500,000 in order to offset higher costs. The tremendous increase in the average amount of registration costs associated with new securities issues over the past several years is graphically illustrated in table 14.-

Table 14

Expenses Incurred In Connection With Firm Commitment Underwritings of Registered Offerings of First Time to Market Companies *

Year	Number of Offerings	Average Registration Expense
1972	478	$120,486
1973	89	$116,817
1974	9	$199,359
1975	5**	$253,000**
1976	21	$217,745
1977	19	$188,366
1978	24	$229,805

* Excludes Real Estate Investment Trusts, Closed End Investment Companies and Commodity Pools.

** Exclude three initial public offerings with an average gross dollar amount of $52,000,000 and an average expense of $510,000.

Source: National Association of Securities Dealers, Inc.

The above registration expense figures include the costs of registration fees, printing, state "blue sky" fees, legal fees, accounting fees and miscellaneous cost items. The figures do not include either the underwriter's spreads or commission charges or any of the legal and marketing expenses of the underwriting group which are often, as a matter of practice, borne by the issuing company.

SUMMARY OF CURRENT DEVELOPMENTS

Clearly, steps must be taken to lighten the burden of expense which the present registration process imposes on an issuer. There are some recent developments in the governmental sector which signal recognition of this problem and are worth noting as the first, but certainly not the final, steps toward rectifying this situation. The Committee has noted the action of Congress to raise the level of funds which the SEC is authorized to exempt from registration pursuant to Regulation A, from $500,000 to $2 million.[47] If the SEC increases the exemption ceiling (the SEC acted to raise the Regulation A offering level to $1.5 million but has yet to determine whether a further increase to $2.0 million is appropriate), issuers wishing to avail themselves of this provision will be able to offset the costs of registration with a smaller percentage amount of their gross offering proceeds. Where before such issuers could have realized a net return of perhaps 80 percent exclusive of underwriter's fees (i.e., $400,000 of a $500,000 Regulation A offering), they may now be able to offset that $100,000 in registration expenses with a threefold increase in offering proceeds.

In response to the problems of small business, the SEC recently announced a series of initiatives designed to ease the burdens of registration and securities distributions. Such measures include: the adoption of Form S-18, a simplified registration form; a proposal to allow use of a preselling document ("red herring") to obtain indications of interest in Regulation A offerings; a proposal to permit the use of earnings estimates and projections by issuers in their offering documents; and, the adoption of amendments to existing Form S-16.

In the case of Form S-18, the Commission has

[47] Securities Act Release No 5967 (November 8, 1978)

recognized the need to provide an alternative means by which small issuers may more easily enter the capital markets. Prior to the adoption of the form, issuers had only a choice between an extensive registration procedure of the type associated with a filing on Form S-1 or the exemptive type of offering pursuant to Regulation A. Using the S-18, a non-reporting issuing company will be permitted to make a registered public offering of up to $5 million utilizing less extensive narrative information than that required by Form S-1 and two year audited statements which need not be prepared in the more elaborate format required in an S-1 filing. Further, issuers are now permitted to use these audited financial statements in their initial annual report on Form 10-K. In addition, the S-18's are to be processed by the SEC's regional offices rather than its Washington headquarters. As explained by SEC Chairman, Harold Williams, in testimony before the Senate Select Committee on Small Business, the rationale behind the then proposed S-18 approach was that ". . . an issuer not subject to the reporting requirements of the Commission at the time the registration statement is filed under the Securities Act [a first time to market company] may, consistent with the protection of investors, raise a limited amount of capital without immediately incurring the full range of disclosure and reporting requirements imposed upon other issuers." [68]

In another initiative, where an offering under Regulation A may be involved, the SEC has looked beyond merely increasing the amount of funds which may be raised thereunder and concerned itself with how issuers utilizing the Regulation A exemption can attract underwriters willing to assume the risks and costs of making such an offering. The lack of sufficient underwriter participation in the Regulation A area is evidenced by the following SEC statistical data:

Table 15

Notifications Filed Under Regulation A

Year	No. of Offerings Under Regulation A	No. of Offerings In Which Underwriters Were Used (% of Total)
1973	817	402(49%)
1974	438	115(26%)
1975	265	44(17%)
1976	240	37(15%)
1977	218	52(24%)
1978	242	55(23%)

Source: Securities and Exchange Commission

[68] Testimony of the Honorable Harold M. Williams, Chairman, SEC, Before the Senate Select Committee on Small Business, September 21, 1978 p. 14

In an effort to halt the steady decline in the number of underwritten Regulation A offerings, the SEC has issued a release proposing to permit underwriters, under certain circumstances, to use a pre-selling document or "red herring" to solicit indications of interest from prospective investors.[69]

In addition to the above, the Commission has investigated the merits of a recommendation made by its Advisory Committee on Corporate Disclosure (Advisory Committee) concerning the publication of forward looking and analytical information in company reports to shareholders and in SEC filings. In this connection, the SEC has proposed two versions of a rule regarding the use of projections by issuers.[70] The second version of the rule (Version B) parallels the recommendation of the Advisory Committee, while the first version (Version A) was developed by the SEC. There are certain differences in the two versions of the rule. Among other things, the Commission's proposal would provide protection from liability for statements made by or on behalf of an issuer, including those made by an outside reviewer of management's projections. The proposal of the Advisory Committee applies such protection only to "management statements." The SEC rule would extend only to projections made in filings with the Commission, while the Committee's proposal would apply to all management projection information whether or not set forth in an SEC filing. While this Committee favors the approach taken by the Advisory Committee rather than the rule proposed by the SEC, it is nevertheless appreciative of the effort which has been made by the Commission to address the issue of projections and their use by issuers. The eventual adoption of any rule in this area will no doubt provide underwriters and issuers alike with a better rationale for making a determination as to the price at which to bring an offering to market and, in the process, will hopefully encourage the undertaking of additional new issue ventures. Also, better disclosure will increase protection for investors and in so doing will help avoid the abuses that eventually lead to public withdrawal from the new issues market.

One final item which should be mentioned is the past action by the Commission to amend its existing Form S-16.[71] Under the amendments recently adopted, issuers are permitted to use a simpler and shorter Form S-16 for the registration of certain primary offerings of securities, provided such offerings are made pursuant to a firm commitment underwriting. These amendments, also based

[69] Securities Act Release No 5997 (November 16 1978)
[70] Securities Act Release No 5993 (November 6 1978)
[71] Securities Act Release No 5923 (April 11, 1978)

upon a recommendation of the Advisory Committee, address the need to create a continuous, coordinated and integrated disclosure system for companies subject to the securities acts. The Advisory Committee believed that registration costs and thus, the costs of raising capital would be reduced if such a system could be developed. In essence, it is hoped that the S-16 amendments will eliminate what to many persons is a needless duplication of disclosure and a corresponding duplication of costs to investors. This Committee encourages similar measures on the part of the SEC and is certain that an analysis of the effectiveness of its proposals in the S-16 and other areas will convince the SEC that it is taking the correct approach in dealing with the problems created by spiraling offering expenses.

GENERAL CONCLUSIONS

In its analysis of the costs associated with equity financing by small businesses, the Committee has reached several general conclusions. Among these are the facts that as long as inflation continues to increase, most of the costs associated with underwritings are also likely to rise and that for the reasons cited earlier, including costs, small business financing via the public offering of equity securities is likely to remain at its present levels. While recent initiatives by the Congress and the SEC will likely result, in the Committee's opinion, in a reduction of certain regulatory costs associated with underwriting, there is much that can still be done to reduce further such costs and thereby lessen the inflationary impact of fixed offering expenses.

RECOMMENDATIONS FOR REDUCING THE COST OF EQUITY FINANCING

The Committee believes that the following actions are necessary, at a minimum, if the costs of equity financing are to be reduced further:

- **Limit Underwriter Liability In Connection With Certain SEC Registrations Particularly Those Made Using Form S-16**

  In connection with the recent adoption of amendments to Form S-16 which, among other things, provide for a simpler and shorter process for the registration of firm commitment primary offerings of securities, the SEC noted that it would allow certain documents to be incorporated by reference into the registration statement. The SEC hoped that this procedure would result in an improvement in the quality of disclosure in S-16 and other filings due to the increased care which would necessarily have to be given to the initial preparation of documents which might later be incorporated by reference. Since the adoption of the amendments, however, a number of underwriters have raised concern about their exposure to liability under Section 11 of the Securities Act of 1933 because of misleading statements or material omissions in reports and documents filed with the SEC by incorporation, particularly where the underwriters have played no part in the initial preparation of such material.

  The claim has been that the underwriters have had no opportunity to employ the "due diligence" procedures which would permit them to form a studied opinion of the accuracy of a registration statement involving incorporated documents. Underwriters have also noted that Section 11 imposes liability if any part of a registration statement is untrue or misleading at the time the offering becomes effective. In this connection, they have asserted that "dated" information incorporated by reference in a registration statement may contain a number of inaccuracies occasioned merely by the passage of time. On the other side of the coin, issuers have appeared reluctant to agree to modifications of previously prepared reports being incorporated by reference in an S-16 offering. They fear that any modification would constitute, in effect, an admission that the original document was inaccurate in some respect thus exposing the issuer to the threat of action by investors who could claim to have purchased shares in reliance upon the initial "misleading" disclosure.

  The SEC, in response to the concerns raised by issuers and underwriters, has attempted to remedy the problems currently associated with its Form S-16 amendments. In a recent release, the SEC announced a proposal whereby Form S-16 would be further amended to state that the effective date of any document incorporated by reference, for purposes of determining underwriter liability under Section 11 of the Securities Act of 1933, would be the date of the document's initial filing with the SEC.[72] Also proposed is an amendment which would permit the removal of certain statements from the registration statement which have been superseded or modified either by disclosure in the S-16 prospectus or by a subsequent document filed with the Commission and incorporated by reference.[73] The SEC would allow, in this connection, a disclosure to be made by an

[72] Securities Act Release No 5998 (November 17, 1978)
[73] Ibid.

issuer to the effect that a modifying or superseding statement shall not be deemed an admission that the original document contained a material omission or misstatement.

The Committee welcomes the SEC's recognition of the problems presently associated with S-16 offerings and is encouraged that the Commission has determined to take steps to correct this situation. In the Committee's opinion, the professed goals of the previously adopted S-16 amendments, to reduce the costs and duplication associated with the registration process, should be achieved as quickly as possible. Clarifying the liabilities of underwriters and issuers utilizing Form S-16 is a first step in that direction. While it generally supports the intent of the SEC proposal, the Committee believes that the amendments in their present form still would prompt underwriters to perform a more extensive due diligence investigation than would appear necessary given the professed desire of S-16 proponents to reduce the present costs associated with securities offerings. In the Committee's opinion, the amendments do not go far enough to relieve underwriters relying upon the accuracy of documents incorporated by reference from Section 11 liability. In the SEC's own words, disclosures incorporated by reference in Form S-16 ". . . still would be subject to scrutiny to determine whether they met with Section 11 standards at the time such disclosure was filed." [74] This being the case, it would appear that nothing short of a full "due diligence" investigation by an underwriter would be warranted. The performance of such an investigation could only add to the expenses associated with an S-16 filing and prolong the time that such filing is in registration. Such would seem to defeat the primary purpose of an issuer in choosing to use this filing document.

The Committee recommends that the Commission give further consideration to its present proposals perhaps approaching the issues raised from the standpoint of indemnifying underwriters totally from Section 11 liability in connection with material incorporated by reference on Form S-16. The Committee believes that an indemnification rule would be particularly meaningful to underwriters who did not participate in the initial preparation of incorporated documents or had no responsibility for them at the time of the effectiveness of the filing from which they were incorporated. The Committee further believes that after some experience period, the S-16 idea be extended to smaller issuers as well, i.e., those falling below the S-7 level.

[74] Ibid.

- **Consider Indemnification for Attorneys and Accountants Rendering Services to Issuers**

In testimony before the Senate Select Committee on Small Business, SEC Chairman Williams said that "The involvement of underwriters, accountants and attorneys in the securities offering process can create significant costs which must be borne by the small business issuer." [75] As previously noted, the Commission has taken steps in an attempt to lessen the burden imposed on issuers in the form of underwriting, registration and auditing expenses through amendments to Form S-16 and the recent adoption of a new Form S-18 registration statement. Recognizing that the burdens of registration and its related costs weigh heavier on a small company, the Committee suggests that one solution to this problem could be the development of a form of indemnification for attorneys and accountants who participate in the preparation of registration statements. Since such persons generally pass along the costs of their services to their new issue clients and since the costs associated with equity financings have increased dramatically and will continue to do so in the future, there must be some means devised to limit the expense associated with employing such persons. This issue has, in fact, already been actively considered by a number of other groups. Again, as Chairman Williams indicated in his testimony, one factor in the increasing costs associated with professional services is the increase in premiums for liability insurance covering legal and accounting opinions.[76] To combat these rising costs, Williams noted that the suggestion had been made to limit the liability of attorneys and accountants in connection with their securities activity to either some multiple of their fees or a fixed percentage of the gross offering proceeds." [77] In this manner, a cap or upper limit could be put on the amount of liability insurance which would be needed in connection with the filing of a new offering. The imposition of such a limit would result, hopefully, in the reduction of the amount of insurance which would have

[75] Williams, p. 21.
[76] Williams, p. 22
[77] Williams, p. 23.

63-769 O - 80 - 21

to be carried by such persons, and, in turn, cause the insurance premiums to also decrease. The beneficiary of any cost savings in this area would eventually be the company undertaking a new financing.

- **Establishment of a Special Reserve for Market Makers**

  Perhaps the greatest possible incentive to increased underwriting activity by broker-dealers would, in the Committee's opinion, be the creation of a special reserve for market makers. This concept, which was discussed earlier in this Report, bears repeating as a step which can be taken to improve small businesses' access to equity markets. Briefly stated, the availability of special tax-deferred reserves for broker-dealers will undoubtedly encourage increased market making activity, particularly in issues of small and developing companies, by small and medium size broker-dealers. This increased activity would add to the depth and liquidity of the equities marketplace and the breadth of investment decision making to the benefit of investors and issuers alike. The existence of a healthy aftermarket for securities offered to the public is key to the success of the underwritings which follow.

- **Adoption of a Uniform Exemption From Registration**

  Great strides have been taken recently by both the North American Securities Administrators Association (NASAA) and several state securities commissioners to replace existing "blue sky" exemptions from registration for listed securities with a uniform exemption from registration. Accordingly, securities of any issuer meeting specified objective standards irrespective of listing status would be exempt from state registration. Thus, the quality of the security rather than the marketplace would become the important factor. The uniform exemption has many advantages over existing "blue sky" exemptions, particularly for issuers whose securities are not listed on a national securities exchange. While the securities of such issuers may be of equal or higher quality than certain exchange listed stocks and may qualify for exchange listing should they choose to seek such, they are denied a registration exemption simply because they are not exchange listed. Consequently, quality over-the-counter issuers incur additional time and expense at the state level in marketing new securities while exchange listed companies are spared such burdens due to existing "blue sky" exemptions. The Committee supports the efforts which have been undertaken thus far to remove registration barriers which discriminate in favor of exchange listed companies to the detriment of quality over-the-counter issuers. Adoption of a uniform exemption by all of the states would contribute to the reduction of costs and regulatory burdens presently imposed on certain companies and would perhaps encourage such firms to undertake new issue financings they may not have considered absent a registration exemption.

- **Volatility of New Issues**

  The Committee is hopeful that its recommendations will lead to the creation of an environment in which more broker-dealers will be encouraged to engage in underwriting and market making activities. In so doing, individual investors and developing companies will be better served. If our projections, based upon implementation of our proposals, are correct, firms undertaking new financings, especially first time to market issuers, will be the principal beneficiaries. As a result, there is likely to be a marked increase in the number of public offerings of securities. In this connection, it is imperative that steps be taken now to insure that there will be stable secondary markets for these stocks and that price volatility will not become a concern of investors making a determination on whether to purchase shares of a new issue. Presently, underwriters utilize overallotment options and enter stabilizing bid quotations in order to satisfy investor demand for additional shares to stock and to maintain the price of an issue at or near its public offering price until the shares offered have been distributed by the syndicate members in an orderly manner. Both actions serve to check the volatility of new issues by stabilizing their secondary markets. While these methods seem to function reasonably well under most circumstances, there are some problems which have surfaced and which need to be addressed.

  First, the Committee believes that the Commission, through rulemaking or otherwise, should permit underwriters to exercise an over-allotment option at any time until the final settlement of an offering. Limiting such exercise to the period prior to the time the syndicate is closed, as is the present practice, limits the effectiveness of this option.

  Current regulations permit a customer to decline to purchase shares of an offering until he has received a copy of the final prospectus. An underwriter which exercises all or a portion of an over-allotment option, based upon indications of interest received that a certain number of shares of a new issue will be purchased by the public, could be left with unsold securities should the number of actual purchasers and/or the size of their stock purchases on the date of settlement be fewer than expected. Having unsold shares leaves an underwriter at risk should a price decline occur. Additionally, current syndicate practices make it difficult for a managing underwriter to know precisely how well placed an issue is. Under these conditions, a relatively small amount of shares, aggressively sold during the first few days of a new issue distribution, can have the effect of significantly lowering the price of the stock. A managing underwriter can effectively address these situations and stabilize the market by exercising his overallotment option, if demand is great, or by letting it expire, if it fails to materialize. Generally, however, the managing underwriter is not in a position to know the precise situation, in terms of demand, at the time the syndicate closes. He needs additional time in which to decide whether to exercise his overallotment option. This committee believes that such additional time should run to the date of final settlement with the issuer.

Second, some action must be taken to eliminate disruptive practices such as "shorting into the syndicate bid." In this situation, an individual or individuals "attacks" the underwriting syndicate bid with orders or indications of interest to sell shares of a new issue—shares which the seller normally does not own. Such selling pressure is designed to force the syndicate to lower its bid to a point where the seller can cover his short position at a profit. A small number of people can therefore benefit at the expense of a larger number of shareholders who purchased stock at the public offering price. The problems created by this situation were recognized by Congress when it outlawed the "short pool" concept for listed securities in adopting the Securities Act of 1933. The Committee believes that some action is necessary, either in the form of a rule proposal or otherwise, to put an end to this practice. The Committee has taken note of the fact that the Securities and Exchange Commission began to address the problem of short selling in connection with a public offering in February, 1974, when it published for public comment proposed Rule 10b-21. The rule was designed to impose certain limitations on purchases to cover short sales whenever short sales were effected prior to the commencement of an offering involving securities of the same class. Revised versions of the rule were published in April, 1975, and again in December, 1976. The April, 1975, version of the rule is, in the Committee's opinion, worthy of additional consideration since it would address the short selling problem through the regulation of covering transactions but would not impede or inhibit legitimate short selling practices by marketplace participants.

By way of background, under the April, 1975, proposal, covering purchases in connection with a short sale would be prohibited if the short sale was made within a ten-day period before the commencement of an offering and if such covering purchase would be made from an underwriter or other dealer participating in the distribution. In addition, if the short sale was made within five days before the commencement of the offering, covering purchases would be prohibited within a five-day period after the commencement of an offering or before the termination of the offering, whichever is earlier.

The Committee believes that it is appropriate to address the problem of shorting into a syndicate bid through the regulation of covering transactions. The Committee believes that this approach would greatly diminish the incentive for manipulation. From a regulatory standpoint, the Committee further believes that it offers a sound means by which to measure compliance.

- **SEC Office of Small Business Policy**

The Committee is encouraged by the Commission's recent decision to establish an Office of Small Business Policy. The continuing problems of small businesses are ones which warrant specific attention and require affirmative action on the part of legislative and regulatory bodies. In this connection, the Committee recommends that the scope of the new Office be sufficiently broad to go beyond the mere technical aspects of proposed SEC regulations. The Office should, in the Committee's opinion, be able to deal with questions raised during the Commission's recent small business hearings and should be able to comment on the impact of existing SEC rules on small enterprises. The Office should be able to develop as well as implement policy.

CHAPTER NINE

CONCLUSION

Recognition of the problems presently facing small business in this country, although seemingly slow to surface, has recently accelerated to a point where concerns over the lack of available equity financing for small firms have touched large segments of private industry, several branches of the federal government and numerous independent governmental agencies. Indeed, a special White House Conference has been organized specifically to discuss small business, its problems and its needs.

In this connection, the Committee has prepared this Report and made recommendations with a true sense of urgency. As each day passes, the difficulties faced by small businesses grow more acute. Given sufficient time, the trends described in the preceding chapters of this Report which precipitated the withdrawal of individual investors from the marketplace, the contraction of the broker-dealer community and a dearth of equity capital could well become irreversible. The Committee is of the opinion, however, that sufficient time remains in which to reverse this situation. Nevertheless, immediate action must be taken.

The Committee believes that its suggestions are a step in the right direction. If followed, they can contribute measurably to the strengthening of this country's economy through the resurrection of the small business community. Whether those who read the Report agree with the recommendations which we have set forth or whether they believe alternative means are available, it has become clear to the persons involved in the preparation of this document that a proper environment must be developed to encourage small business growth. Continued stagnation in the small business community bodes ill for the future of this nation.

JOINT INDUSTRY/GOVERNMENT COMMITTEE
on
SMALL BUSINESS FINANCING

January 2, 1979

IMPORTANT

TO: Institutional Investors & Professional Portfolio Managers

RE: Special Survey

A Joint Industry and Government Committee presently examining the problems facing small business would like to ask your help in developing data concerning the current investment practices of the nation's leading institutional investors and professional portfolio managers.

The Committee, which was recently formed by the National Association of Securities Dealers, Inc., and composed of representatives from the securities industry and several governmental agencies, is conducting this survey to gain a clearer insight into the problems associated with small business financing and small business investment.

The data derived from this survey will be analyzed and utilized by the Committee in a report it is scheduled to present to the U. S. Senate Select Committee on Small Business early in 1979. Among other things, the Committee is working to develop recommendations which will encourage greater participation in small business investment; make it easier for small and medium sized companies to raise equity capital; and, improve economic incentives for both small and medium sized businesses.

The Committee fully realizes that to complete the enclosed questionnaire, some expenditure of valuable staff time will be required. However, the Committee believes that the final results of this study may have a significant impact on virtually everyone who buys and sells securities. Because of this, the Committee again solicits your full cooperation and urges you to complete the enclosed survey form.

The information derived from these questionnaires will be summarized and used by the Committee solely for informational purposes. To insure complete anonymity of individual replies, the Committee has done two things. First, it determined not to ask respondents to specifically

Re: Special Survey
January 2, 1979
Page Two

identify themselves. Second, it has made an arrangement with Price Waterhouse & Co., independent certified public accountants, to receive and process all questionnaires returned. In that connection, all completed questionnaires should be returned to Price Waterhouse & Co. in the enclosed, self-addressed postage-paid envelope. All replies will be treated by Price Waterhouse & Co. in the strictest confidence.

Your full cooperation will be greatly appreciated.

Sincerely,

William R Hambrecht

William R. Hambrecht, Chairman
Joint Industry/Government Committee
on Small Business Financing

Members:

National Association of Securities Dealers, Inc.
Securities Industry Association
U. S. Senate Select Committee on Small Business

Assisted By:

Various Interested Departments and Agencies of the Federal Government

Attachments

IMPORTANT

SPECIAL SURVEY

of

INSTITUTIONAL INVESTORS
&
PROFESSIONAL PORTFOLIO MANAGERS

January 2, 1979

This Survey is Being Conducted
By the
Joint Industry/Government Committee
On Small Business Financing

Members:

National Association of Securities Dealers, Inc.
Securities Industry Association
U.S. Senate Select Committee on Small Business

Assisted By:

Various Interested Departments and
Agencies of the Federal Government

KINDLY RETURN THIS SURVEY IN THE ENCLOSED ENVELOPE BEFORE JANUARY 22, 1979, TO:

Price Waterhouse & Company
1801 K Street, N.W. (MGP)
Washington, D.C. 20006

INSTRUCTIONS

1. Kindly answer all questions.
2. Estimates may be used whenever precise figures are unavailable.
3. Additional comments on the subject of small business financing and small business investment are invited. Such may be appended to the questionnaire.
4. Inquiries regarding the questionnaire may be directed to Price Waterhouse & Co., Attention of Mrs. Mary Peters - (202) 296-0800, x 335.
5. When completed, detach questionnaire from this cover sheet and forward in the enclosed postage paid envelope to:

   Price Waterhouse & Company
   1801 K Street, N.W. (MGP)
   Washington, D.C. 20006

SPECIAL SURVEY
of
INSTITUTIONAL INVESTORS
&
PROFESSIONAL PORTFOLIO MANAGERS

1. What is the nature of your operation?

☐ Bank Trust Department
☐ Insurance Company
☐ Investment Company/Mutual Fund
☐ Independent Money Manager
☐ College Endowment Fund
☐ Other (Please Specify) ____________

2. What are the sources and percentages of investment funds managed?

☐ Pension Plans ____%
☐ Institutions (Universities, etc.) ____%
☐ Individuals ____%
☐ Other (Please Specify) ____%
____

3. What is the approximate dollar value of assets currently managed (in millions of dollars)?

☐ Under 25 ☐ 51 - 100 ☐ 251 - 500 ☐ 1000 - 10,000
☐ 25 - 50 ☐ 101 - 250 ☐ 501 - 1000 ☐ Over 10,000

4. What percentage of assets currently managed is subject to Employee Retirement Income Security Act (ERISA)?

☐ Less than 25% ☐ 25% - 50% ☐ 51% - 75% ☐ Over 75%

5. Of the total assets managed, what amount is currently invested in common stocks?

☐ Less than 25% ☐ 25% - 50% ☐ 51% - 75% ☐ Over 75%

6. What percentage of these common stock holdings would you estimate is invested in the following types of equity securities?

Listed on NYSE ____%
Listed on AMEX ____%
Listed on Regional Exchanges ____%
OTC-NASDAQ ____%
OTC-Non-NASDAQ ____%
OTC-No Public Market ____%

7. What percentage of new money received in 1978 has been invested in equity securities?

☐ Less than 25% ☐ 25% - 50% ☐ 51% - 75% ☐ Over 75%

8. Do you have any policy, either formal or informal, which requires a minimum level of market capitalization for companies in which you invest?

☐ Yes { ☐ Formal Policy ☐ Informal Policy } ☐ No Policy

9. If your response to Question No. 8 was "yes," what is the minimum market capitalization standard your organization has established (in millions of dollars)?

☐ Under 10 ☐ 51 - 100 ☐ Over 500

☐ 10 - 25 ☐ 101 - 250

☐ 26 - 50 ☐ 251 - 500

10. If you do not invest in companies with a capitalization of less than $50 million, please indicate the reasons for such by ranking them from "most important" (1) to "least important" (8), as applicable.

_______ ERISA Concerns _______ Lack of Financial History

_______ Price Volatility _______ Lack of Independent Research

_______ Lack of Liquidity _______ Cost of In-House Research

_______ Difficulty in Valuation _______ Other (Please Specify) _______________

11. Would you favor a change in ERISA or in the administration thereof to encourage investment in small companies (i.e., securities which are presently excluded from your universe of investment to the extent ERISA is a factor)?

☐ Yes ☐ No ☐ No Opinion

12. If your response to Question No. 11 was "yes," do you favor either of the following?

Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."

☐ Yes ☐ No

Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration.

☐ Yes ☐ No

13. What other incentives, if any, do you favor to encourage small business investment?

☐ Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses

☐ Legislation to provide additional capital gains tax relief

☐ Other (Please Explain): _______________

____

____

☐ None

☐ No Opinion

SPECIAL SURVEY OF INSTITUTIONAL INVESTORS & PROFESSIONAL PORTFOLIO MANAGERS

TABLE OF CONTENTS

JOINT INDUSTRY/GOVERNMENT COMMITTEE ON SMALL BUSINESS FINANCING

SPECIAL SURVEY OF INSTITUTIONAL INVESTORS AND PROFESSIONAL PORTFOLIO MANAGERS

Tabulation of Responses By Nature of Operation

Description	Total	National Bank Trust Departments	Insurence Companies	Investment Companies	Independent Money Managers	College & University Endowment Funds	Others
Survey Population	1940	186	1056	609	—	89	—
Responses Received Individual Replies (537 Responses) *	558	84	290	121	26	24	13
Multiple Replies (9 Responses) **	37	—	26	11	—	—	—
Total Responses	595	84	316	132	26	24	13
Response Rate (%)	30.7%	45.2%	29.9%	21.7%	—	27.0%	—

Notes: * Some respondents indicated more than one business activity.
** Nine of the 537 respondents said they were responding on their own behalf and on behalf of 37 other entities.

Source: NASD Survey.

SPECIAL SURVEY OF
INSTITUTIONAL INVESTORS & PROFESSIONAL PORTFOLIO MANAGERS
RESULTS FOR ALL ORGANIZATIONS

537 Surveys Tabulated

	Responses [1]	Percent	Responses [2]	Average % [3]
1. WHAT IS THE NATURE OF YOUR OPERATION?	537	100.0%		
Bank Trust Department	84	15.6%		
Insurance Company	290	54.0%		
Investment Company/Mutual Fund	121	22.5%		
Independent Money Manager	26	4.8%		
College Endowment Fund	24	4.5%		
Other	13	2.4%*		
2. WHAT ARE THE SOURCES AND PERCENTAGES OF INVESTMENT FUNDS MANAGED?	516	100.0%		
Pension Plans	261	50.6%	249	27.66%
25% or less			154	11.17%
26%—50%			51	37.35%
51%—75%			28	62.46%
Over 75%			16	94.90%
Institutions (Universities, etc.)	175	33.9%	169	36.17%
25% or less			111	8.89%
26%—50%			7	32.14%
51%—75%			4	71.75%
Over 75%			47	98.19%
Individuals	376	72.9%	369	79.43%
25% or less			25	13.36%
26%—50%			39	40.74%
51%—75%			62	64.54%
Over 75%			243	96.20%
Other	123	23.8%	120	67.30%
25% or less			33	11.78%
26%—50%			11	39.00%
51%—75%			6	68.50%
Over 75%			70	97.70%
3. WHAT IS THE APPROXIMATE DOLLAR VALUE OF ASSETS CURRENTLY MANAGED (IN MILLIONS OF DOLLARS)?	535	100.0%		
Under 25	96	17.9%		
25—50	59	11.0%		
51—100	60	11.2%		
101—250	87	16.3%		
251—500	77	14.4%		
501—1000	58	10.8%		
1000—10,000	91	17.0%		
Over 10,000	7	1.3%		

Notes:
1. Number responding to question.
2. Number responding with a percentage.
3. Average of percentages provided by respondents.

* Because of multiple answers, these add up to 103.8%.

	Responses	Percent	Responses	Average %
4. WHAT PERCENTAGE OF ASSETS CURRENTLY MANAGED IS SUBJECT TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)?	514	100.0%		
Less than 25%	410	79.8%		
26%—50%	64	12.5%		
51%—75%	27	5.3%		
Over 75%	13	2.5%		
5. OF THE TOTAL ASSETS MANAGED, WHAT AMOUNT IS CURRENTLY INVESTED IN COMMON STOCKS?	532	100.0%		
Less than 25%	286	53.8%		
26%—50%	104	19.5%		
51%—75%	79	14.8%		
Over 75%	63	11.8%		
6. WHAT PERCENTAGE OF THESE COMMON STOCK HOLDINGS WOULD YOU ESTIMATE IS INVESTED IN THE FOLLOWING TYPES OF EQUITY SECURITIES?	509	100.0%		
Listed on NYSE	500	98.2%		86.26%
25% or less			12	14.50%
26%—50%			17	40.35%
51%—75%			51	67.39%
Over 75%			420	92.46%
Listed on AMEX	260	51.1%		7.82%
25% or less			249	6.14%
26%—50%			8	32.00%
51%—75%			1	65.00%
Over 75%			2	92.50%
Listed on Regional Exchanges	46	9.0%		5.78%
25% or less			45	4.13%
26%—50%			—	—
51%—75%			—	—
Over 75%			1	80.00%
OTC—NASDAQ	357	70.1%		10.73%
25% or less			329	7.83%
26%—50%			22	37.04%
51%—75%			5	71.40%
Over 75%			1	83.00%
OTC—Non-NASDAQ	39	7.7%		5.92%
25% or less			37	3.94%
26%—50%			1	30.00%
51%—75%			1	55.00%
Over 75%			—	—
OTC—No Public Market	76	14.9%		18.02%
25% or less			61	4.65%
26%—50%			6	42.33%
51%—75%			2	72.50%
Over 75%			7	98.14%
7. WHAT PERCENTAGE OF NEW MONEY RECEIVED IN 1978 HAS BEEN INVESTED IN EQUITY SECURITIES?	521	100.0%		
Less than 25%	329	63.1%		
25%—50%	87	16.7%		
51%—75%	47	9.0%		
Over 75%	58	11.1%		

	Responses	Percent
8. DO YOU HAVE ANY POLICY, EITHER FORMAL OR INFORMAL WHICH REQUIRES A MINIMUM LEVEL OF MARKET CAPITALIZATION FOR COMPANIES IN WHICH YOU INVEST?	535	100.0%
Yes	317	59.3%
Formal Policy	87	16.3%
Informal Policy	225	42.1%
No Policy	218	40.7%

	Responses	Percent
9. IF YOUR RESPONSE TO QUESTION NO. 8 WAS "YES", WHAT IS THE MINIMUM MARKET CAPITALIZATION STANDARD YOUR ORGANIZATION HAS ESTABLISHED (IN MILLIONS OF DOLLARS)?	307	100.0%
Under 10	29	9.4%
10—25	41	13.4%
26—50	51	13.4%
51—100	86	28.0%
101—250	71	23.1%
251—500	22	7.2%
Over 500	7	2.3%

10. IF YOU *DO NOT* INVEST IN COMPANIES WITH A CAPITALIZATION OF LESS THAN $50 MILLION, PLEASE INDICATE THE REASONS FOR SUCH BY RANKING THEM FROM "MOST IMPORTANT" (1) TO "LEAST IMPORTANT" (8), AS APPLICABLE.

5.10	ERISA Concerns [4]
3.18	Price Volatility
1.71	Lack of Liquidity
3.93	Difficulty in Valuation
4.05	Lack of Financial History
3.22	Lack of Independent Research
4.14	Cost of In-House Research
4.47	Other

	Responses	Percent
11. WOULD YOU FAVOR A CHANGE IN ERISA OR IN THE ADMINISTRATION THEREOF TO ENCOURAGE INVESTMENT IN SMALL COMPANIES (I.E., SECURITIES WHICH ARE PRESENTLY EXCLUDED FROM YOUR UNIVERSE OF INVESTMENT TO THE EXTENT ERISA IS A FACTOR)?	521	100.0%
Yes	199	38.2%
No	71	13.6%
No Opinion	251	48.2%

12. IF YOUR RESPONSE TO QUESTION NO. 11 was "YES," DO YOU FAVOR EITHER OF THE FOLLOWING?

	Responses	Percent
Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."	201	100.0%
Yes	171	85.1%
No	30	14.9%

Note 4: Mean ranking given by respondents.

	Responses	Percent
Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration	175	100.0%
Yes	152	86.9%
No	23	13.1%
13. WHAT OTHER INCENTIVES, IF ANY, DO YOU FAVOR TO ENCOURAGE SMALL BUSINESS INVESTMENT?	524	100.0%
Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses	147	28.1%
Legislation to provide additional capital gains tax relief	336	64.1%
Other	80	15.3%
None	26	5.0%
No Opinion	104	19.8%

SPECIAL SURVEY OF INSTITUTIONAL INVESTORS & PROFESSIONAL PORTFOLIO MANAGERS RESULTS FOR BANK TRUST DEPARTMENTS

84 Surveys Tabulated

	Responses [1]	Percent
1. WHAT IS THE NATURE OF YOUR OPERATION?		
Bank Trust Department	84	100.0%
Insurance Company		
Investment Company/Mutual Fund		
Independent Money Manager		
College Endowment Fund		
Other		

	Responses [1]	Percent	Responses [2]	Average % [3]
2. WHAT ARE THE SOURCES AND PERCENTAGES OF INVESTMENT FUNDS MANAGED?	82	100.0%		
Pension Plans	82	100.0%	79	32.50%
25% or less			36	18.75%
26%—50%			29	36.03%
51%—75%			14	60.57%
Over 75%			—	—
Institutions (Universities, etc.)	63	76.8%	61	8.88%
25% or less			60	8.53%
26%—50%			1	30.00%
51%—75%			—	—
Over 75%			—	—
Individuals	82	100.0%	79	56.91%
25% or less			7	17.57%
26%—50%			19	40.78%
51%—75%			43	64.11%
Over 75%			10	84.10%
Other	14	17.1%	14	20.60%
25% or less			12	11.58%
26%—50%			—	—
51%—75%			1	55.00%
Over 75%			1	95.00%

	Responses [1]	Percent
3. WHAT IS THE APPROXIMATE DOLLAR VALUE OF ASSETS CURRENTLY MANAGED (IN MILLIONS OF DOLLARS)?	84	100.0%
Under 25	—	—
25—50	—	—
51—100	—	—
101—250	12	14.3%
251—500	31	36.9%
501—1000	17	20.2%
1000—10,000	22	26.2%
Over 10,000	2	2.4%

Notes: 1. Number responding to question.
2. Number responding with a percentage.
3. Average of percentages provided by respondents.

63-769 0 - 80 - 22

	Responses	Percent
4. WHAT PERCENTAGE OF ASSETS CURRENTLY MANAGED IS SUBJECT TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)?	83	100.0%
Less than 25%	36	43.4%
26%—50%	34	41.0%
51%—75%	13	15.7%
Over 75%	—	—
5. OF THE TOTAL ASSETS MANAGED, WHAT AMOUNT IS CURRENTLY INVESTED IN COMMON STOCKS?	83	100.0%
Less than 25%	1	1.2%
26%—50%	51	61.4%
51%—75%	30	36.1%
Over 75%	1	1.2%

	Responses	Percent	Responses	Average %
6. WHAT PERCENTAGE OF THESE COMMON STOCK HOLDINGS WOULD YOU ESTIMATE IS INVESTED IN THE FOLLOWING TYPES OF EQUITY SECURITIES?	80	100.0%		
Listed on NYSE	80	100.0%		86.65%
25% or less			1	20.00%
26%—50%			—	—
51%—75%			7	65.57%
Over 75%			72	89.62%
Listed on AMEX	47	71.3%		5.28%
25% or less			57	5.28%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
Listed on Regional Exchanges	19	23.8%		8.15%
25% or less			18	4.16%
26%—50%			—	—
51%—75%			—	—
Over 75%			1	80.00%
OTC—NASDAQ	71	88.8%		7.25%
25% or less			70	6.96%
26%—50%			1	28.00%
51%—75%			—	—
Over 75%			—	—
OTC—Non-NASDAQ	12	15.0%		2.33%
25% or less			12	2.33%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—No Public Market	23	28.8%		2.60%
25% or less			23	2.60%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—

	Responses	Percent
7. WHAT PERCENTAGE OF NEW MONEY RECEIVED IN 1978 HAS BEEN INVESTED IN EQUITY SECURITIES?	83	100.0%
Less than 25%	22	26.5%
25%—50%	46	55.4%
51%—75%	14	16.9%
Over 75%	1	1.2%

	Responses	Percent
8. DO YOU HAVE ANY POLICY, EITHER FORMAL OR INFORMAL WHICH REQUIRES A MINIMUM LEVEL OF MARKET CAPITALIZATION FOR COMPANIES IN WHICH YOU INVEST?	84	100.0%
Yes	68	81.0%
Formal Policy	27	32.1%
Informal Policy	39	46.4%
No Policy	16	19.0%
9. IF YOUR RESPONSE TO QUESTION NO. 8 WAS "YES," WHAT IS THE MINIMUM MARKET CAPITALIZATION STANDARD YOUR ORGANIZATION HAS ESTABLISHED (IN MILLIONS OF DOLLARS)?	67	100.0%
Under 10	2	3.0%
10—25	7	10.4%
26—50	10	14.9%
51—100	20	29.9%
101—250	20	29.9%
251—500	8	11.9%
Over 500	—	—

10. IF YOU *DO NOT* INVEST IN COMPANIES WITH A CAPITALIZATION OF LESS THAN $50 MILLION, PLEASE INDICATE THE REASONS FOR SUCH BY RANKING THEM FROM "MOST IMPORTANT" (1) TO "LEAST IMPORTANT" (8), AS APPLICABLE.

- 4.10 ERISA Concerns[4]
- 3.19 Price Volatility
- 1.67 Lack of Liquidity
- 5.20 Difficulty In Valuation
- 4.07 Lack of Financial History
- 2.95 Lack of Independent Research
- 4.25 Cost of In-House Research
- 6.83 Other

	Responses	Percent
11. WOULD YOU FAVOR A CHANGE IN ERISA OR IN THE ADMINISTRATION THEREOF TO ENCOURAGE INVESTMENT IN SMALL COMPANIES (I.E., SECURITIES WHICH ARE PRESENTLY EXCLUDED FROM YOUR UNIVERSE OF INVESTMENT TO THE EXTENT ERISA IS A FACTOR)?	84	100.0%
Yes	35	41.7%
No	28	33.3%
No Opinion	21	25.0%

12. IF YOUR RESPONSE TO QUESTION NO. 11 was "YES," DO YOU FAVOR EITHER OF THE FOLLOWING?

	Responses	Percent
Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."	33	100.0%
Yes	30	90.9%
No	3	9.1%

Note 4: Mean ranking given by respondents.

	Responses	Percent
Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration	33	100.0%
Yes	29	87.9%
No	4	12.1%

	Responses	Percent
13. WHAT OTHER INCENTIVES, IF ANY, DO YOU FAVOR TO ENCOURAGE SMALL BUSINESS INVESTMENT?	83	100.0%
Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses	22	26.5%
Legislation to provide additional capital gains tax relief	61	73.5%
Other	9	10.8%
None	6	7.2%
No Opinion	10	12.0%

SPECIAL SURVEY OF
INSTITUTIONAL INVESTORS & PROFESSIONAL PORTFOLIO MANAGERS
RESULTS FOR INSURANCE COMPANIES

290 Surveys Tabulated

	Responses[1]	Percent	Responses[2]	Average %[3]
1. WHAT IS THE NATURE OF YOUR OPERATION?				
Bank Trust Department	—	—		
Insurance Company	290	100.0%		
Investment Company/Mutual Fund	4	1.4%		
Independent Money Manager	1	0.3%		
College Endowment Fund	—	—		
Other	4	1.4%		
2. WHAT ARE THE SOURCES AND PERCENTAGES OF INVESTMENT FUNDS MANAGED?	276	100.0%		
Pension Plans	99	35.9%	94	22.65%
25% or less			69	7.08%
26%—50%			11	39.00%
51%—75%			5	62.40%
Over 75%			9	100.00%
Institutions (Universities, etc.)	29	10.5%	28	91.60%
25% or less			2	3.00%
26%—50%			—	—
51%—75%			—	—
Over 75%			26	98.42%
Individuals	180	65.2%	178	92.63%
25% or less			2	12.50%
26%—50%			9	44.77%
51%—75%			9	64.44%
Over 75%			158	98.00%
Other	70	25.4%	68	86.90%
25% or less			5	14.00%
26%—50%			5	42.00%
51%—75%			3	71.66%
Over 75%			55	98.50%
3. WHAT IS THE APPROXIMATE DOLLAR VALUE OF ASSETS CURRENTLY MANAGED (IN MILLIONS OF DOLLARS)?	289	100.0%		
Under 25	52	18.0%		
25—50	40	13.8%		
51—100	37	12.8%		
101—250	54	18.7%		
251—500	30	10.4%		
501—1000	32	11.1%		
1000—10,000	39	13.5%		
Over 10,000	5	1.7%		

Notes: 1. Number responding to question.
2. Number responding with a percentage.
3. Average of percentages provided by respondents.

	Responses	Percent	Responses	Average %
4. WHAT PERCENTAGE OF ASSETS CURRENTLY MANAGED IS SUBJECT TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)?	281	100.0%		
Less than 25%	254	90.4%		
26%—50%	15	5.3%		
51%—75%	4	1.4%		
Over 75%	8	2.8%		
5. OF THE TOTAL ASSETS MANAGED, WHAT AMOUNT IS CURRENTLY INVESTED IN COMMON STOCKS?	288	100.0%		
Less than 25%	252	87.5%		
26%—50%	26	9.0%		
51%—75%	6	2.1%		
Over 75%	4	1.4%		
6. WHAT PERCENTAGE OF THESE COMMON STOCK HOLDINGS WOULD YOU ESTIMATE IS INVESTED IN THE FOLLOWING TYPES OF EQUITY SECURITIES?	282	100.0%		
Listed on NYSE	276	97.9%		88.79%
25% or less			4	17.00%
26%—50%			9	40.66%
51%—75%			23	68.65%
Over 75%			240	93.72%
Listed on AMEX	107	37.9%		8.16%
25% or less			102	6.25%
26%—50%			4	34.00%
51%—75%			—	—
Over 75%			1	100.00%
Listed on Regional Exchanges	10	3.5%		3.30%
25% or less			10	3.30%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—NASDAQ	169	59.9%		9.80%
25% or less			159	7.59%
26%—50%			8	37.50%
51%—75%			2	75.00%
Over 75%			—	—
OTC—Non-NASDAQ	12	4.3%		6.83%
25% or less			11	4.72%
26%—50%			1	30.00%
51%—75%			—	—
Over 75%			—	—
OTC—No Public Market	42	14.9%		24.28%
25% or less			30	6.73%
26%—50%			6	42.33%
51%—75%			1	70.00%
Over 75%			5	96.80%
7. WHAT PERCENTAGE OF NEW MONEY RECEIVED IN 1976 HAS BEEN INVESTED IN EQUITY SECURITIES?	286	100.0%		
Less than 25%	261	91.3%		
26%—50%	16	5.6%		
51%—75%	3	1.0%		
Over 75%	6	2.1%		

	Responses	Percent
8. DO YOU HAVE ANY POLICY, EITHER FORMAL OR INFORMAL WHICH REQUIRES A MINIMUM LEVEL OF MARKET CAPITALIZATION FOR COMPANIES IN WHICH YOU INVEST?	289	100.0%
Yes	149	51.6%
Formal Policy	38	13.1%
Informal Policy	109	37.7%
No Policy	140	48.4%
9. IF YOUR RESPONSE TO QUESTION NO. 8 WAS "YES," WHAT IS THE MINIMUM MARKET CAPITALIZATION STANDARD YOUR ORGANIZATION HAS ESTABLISHED (IN MILLIONS OF DOLLARS)?	142	100.0%
Under 10	16	11.3%
10—25	11	7.7%
26—50	21	14.8%
51—100	46	32.4%
101—250	34	23.9%
251—500	8	5.6%
Over 500	6	4.2%

10. IF YOU *DO NOT* INVEST IN COMPANIES WITH A CAPITALIZATION OF LESS THAN $50 MILLION, PLEASE INDICATE THE REASONS FOR SUCH BY RANKING THEM FROM "MOST IMPORTANT" (1) TO "LEAST IMPORTANT" (8), AS APPLICABLE.

- 5.90 ERISA Concerns [4]
- 3.28 Price Volatility
- 1.86 Lack of Liquidity
- 3.28 Difficulty in Valuation
- 3.84 Lack of Financial History
- 3.23 Lack of Independent Research
- 3.85 Cost of In-House Research
- 4.33 Other

	Responses	Percent
11. WOULD YOU FAVOR A CHANGE IN ERISA OR IN THE ADMINISTRATION THEREOF TO ENCOURAGE INVESTMENT IN SMALL COMPANIES (I.E., SECURITIES WHICH ARE PRESENTLY EXCLUDED FROM YOUR UNIVERSE OF INVESTMENT TO THE EXTENT ERISA IS A FACTOR)?	281	100.0%
Yes	96	34.2%
No	24	8.5%
No Opinion	161	57.3%
12. IF YOUR RESPONSE TO QUESTION NO. 11 was "YES", DO YOU FAVOR EITHER OF THE FOLLOWING?		
Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."	97	100.0%
Yes	88	90.7%
No	9	9.3%

Note 4: Mean ranking given by respondents.

	Responses	Percent
Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration	80	100.0%
Yes	70	87.5%
No	10	12.5%
13. WHAT OTHER INCENTIVES, IF ANY, DO YOU FAVOR TO ENCOURAGE SMALL BUSINESS INVESTMENT?	282	100.0%
Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses	76	27.0%
Legislation to provide additional capital gains tax relief	169	59.9%
Other	44	15.6%
None	16	5.7%
No Opinion	65	23.0%

SPECIAL SURVEY OF INSTITUTIONAL INVESTORS & PROFESSIONAL PORTFOLIO MANAGERS RESULTS FOR INVESTMENT COMPANIES/MUTUAL FUNDS

121 Surveys Tabulated

	Responses[1]	Percent	Responses[2]	Average %[3]
1. WHAT IS THE NATURE OF YOUR OPERATION?				
Bank Trust Department	—	—		
Insurance Company	4	3.3%		
Investment Company/Mutual Fund	121	100.0%		
Independent Money Manager	10	8.3%		
College Endowment Fund	—	—		
Other	2	1.7%		
2. WHAT ARE THE SOURCES AND PERCENTAGES OF INVESTMENT FUNDS MANAGED?	117	100.0%		
Pension Plans	65	55.6%	61	20.96%
25% or less			47	10.91%
26%—50%			8	40.25%
51%—75%			3	58.33%
Over 75%			3	90.00%
Institutions (Universities, etc.)	47	40.2%	44	13.84%
25% or less			38	8.00%
26%—50%			3	30.00%
51%—75%			3	71.66%
Over 75%			—	—
Individuals	101	86.3%	99	81.31%
25% or less			7	14.71%
26%—50%			7	37.28%
51%—75%			10	65.00%
Over 75%			75	93.80%
Other	30	25.6%	29	46.9%
25% or less			12	11.50%
26%—50%			6	36.50%
51%—75%			1	75.00%
Over 75%			10	92.90%
3. WHAT IS THE APPROXIMATE DOLLAR VALUE OF ASSETS CURRENTLY MANAGED (IN MILLIONS OF DOLLARS)?	121	100.0%		
Under 25	34	28.1%		
25—50	15	12.4%		
51—100	20	16.5%		
101—250	14	11.6%		
251—500	11	9.1%		
501—1000	6	5.0%		
1000—10,000	21	17.4%		
Over 10,000	—	—		

Notes: 1. Number responding to question.
2. Number responding with a percentage.
3. Average of percentages provided by respondents.

	Responses	Percent	Responses	Average %
4. WHAT PERCENTAGE OF ASSETS CURRENTLY MANAGED IS SUBJECT TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)?	114	100.0%		
Less than 25%	98	86.0%		
26%—50%	9	7.9%		
51%—75%	4	3.5%		
Over 75%	3	2.6%		
5. OF THE TOTAL ASSETS MANAGED, WHAT AMOUNT IS CURRENTLY INVESTED IN COMMON STOCKS?	119	100.0%		
Less than 25%	27	22.7%		
26%—50%	14	11.8%		
51%—75%	24	20.2%		
Over 75%	54	45.4%		
6. WHAT PERCENTAGE OF THESE COMMON STOCK HOLDINGS WOULD YOU ESTIMATE IS INVESTED IN THE FOLLOWING TYPES OF EQUITY SECURITIES?	107	100.0%		
Listed on NYSE	105	98.1%		77.97%
25% or less			7	12.28%
26%—50%			7	38.57%
51%—75%			19	66.78%
Over 75%			72	91.13%
Listed on AMEX	73	68.2%		9.84%
25% or less			67	6.70%
26%—50%			4	30.00%
51%—75%			1	65.00%
Over 75%			1	85.00%
Listed on Regional Exchanges	10	9.3%		6.10%
25% or less			10	6.10%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—NASDAQ	90	84.1%		15.96%
25% or less			74	9.59%
26%—50%			12	36.41%
51%—75%			3	69.00%
Over 75%			1	83.00%
OTC—Non-NASDAQ	12	11.2%		9.25%
25% or less			11	5.09%
26%—50%			—	—
51%—75%			1	55.00%
Over 75%			—	—
OTC—No Public Market	8	7.5%		23.50%
25% or less			6	3.33%
26%—50%			—	—
51%—75%			1	75.00%
Over 75%			1	93.00%
7. WHAT PERCENTAGE OF NEW MONEY RECEIVED IN 1978 HAS BEEN INVESTED IN EQUITY SECURITIES?	110	100.0%		
Less than 25%	36	32.7%		
25%—50%	13	11.8%		
51%—75%	15	13.6%		
Over 75%	46	41.8%		

	Responses	Percent
8. DO YOU HAVE ANY POLICY, EITHER FORMAL OR INFORMAL WHICH REQUIRES A MINIMUM LEVEL OF MARKET CAPITALIZATION FOR COMPANIES IN WHICH YOU INVEST?	120	100.0%
Yes	79	65.8%
Formal Policy	13	10.8%
Informal Policy	66	55.0%
No Policy	41	34.2%
9. IF YOUR RESPONSE TO QUESTION NO. 8 WAS "YES," WHAT IS THE MINIMUM MARKET CAPITALIZATION STANDARD YOUR ORGANIZATION HAS ESTABLISHED (IN MILLIONS OF DOLLARS)?	77	100.0%
Under 10	10	13.0%
10—25	18	23.4%
26—50	14	18.2%
51—100	17	22.1%
101—250	13	16.9%
251—500	4	5.2%
Over 500	1	1.3%

10. IF YOU *DO NOT* INVEST IN COMPANIES WITH A CAPITALIZATION OF LESS THAN $50 MILLION, PLEASE INDICATE THE REASONS FOR SUCH BY RANKING THEM FROM "MOST IMPORTANT" (1) TO "LEAST IMPORTANT" (8), AS APPLICABLE.

5.30	ERISA Concerns [4]
2.88	Price Volatility
1.54	Lack of Liquidity
4.00	Difficulty in Valuation
4.83	Lack of Financial History
3.33	Lack of Independent Research
4.42	Cost of In-House Research
3.25	Other

	Responses	Percent
11. WOULD YOU FAVOR A CHANGE IN ERISA OR IN THE ADMINISTRATION THEREOF TO ENCOURAGE INVESTMENT IN SMALL COMPANIES (I.E., SECURITIES WHICH ARE PRESENTLY EXCLUDED FROM YOUR UNIVERSE OF INVESTMENT TO THE EXTENT ERISA IS A FACTOR)?	117	100.0%
Yes	55	47.0%
No	15	12.8%
No Opinion	47	40.2%
12. IF YOUR RESPONSE TO QUESTION NO. 11 was "YES," DO YOU FAVOR EITHER OF THE FOLLOWING?		
Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."	55	100.0%
Yes	40	72.7%
No	15	27.3%

Note 4: Mean ranking given by respondents.

	Responses	Percent
Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration	51	100.0%
Yes	44	86.3%
No	7	13.7%
13. WHAT OTHER INCENTIVES, IF ANY, DO YOU FAVOR TO ENCOURAGE SMALL BUSINESS INVESTMENT?	118	100.0%
Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses	39	33.1%
Legislation to provide additional capital gains tax relief	87	73.7%
Other	22	18.6%
None	3	2.5%
No Opinion	13	11.0%

SPECIAL SURVEY OF INSTITUTIONAL INVESTORS & PROFESSIONAL PORTFOLIO MANAGERS RESULTS FOR INDEPENDENT MONEY MANAGERS

26 Surveys Tabulated

	Responses [1]	Percent
1. WHAT IS THE NATURE OF YOUR OPERATION?		
Bank Trust Department	—	—
Insurance Company	1	3.8%
Investment Company/Mutual Fund	10	38.5%
Independent Money Manager	26	100.0%
College Endowment Fund	—	—
Other	—	—

	Responses [1]	Percent	Responses [2]	Average % [3]
2. WHAT ARE THE SOURCES AND PERCENTAGES OF INVESTMENT FUNDS MANAGED?	25	100.0%		
Pension Plans	22	88.0%	21	52.57%
25% or less			4	21.25%
26%—50%			6	38.50%
51%—75%			8	66.12%
Over 75%			3	86.30%
Institutions (Universities, etc.)	22	88.0%	21	25.76%
25% or less			15	12.33%
26%—50%			3	35.00%
51%—75%			1	75.00%
Over 75%			2	88.00%
Individuals	17	68.0%	17	31.82%
25% or less			8	8.50%
26%—50%			5	33.20%
51%—75%			2	63.50%
Over 75%			2	90.00%
Other	9	36.0%	9	23.80%
25% or less			7	16.14%
26%—50%			1	35.00%
51%—75%			1	66.00%
Over 75%			—	—

	Responses [1]	Percent
3. WHAT IS THE APPROXIMATE DOLLAR VALUE OF ASSETS CURRENTLY MANAGED (IN MILLIONS OF DOLLARS)?	26	100.0%
Under 25	1	3.8%
25—50	2	7.7%
51—100	3	11.5%
101—250	3	11.5%
251—500	5	19.2%
501—1000	2	7.7%
1000—10,000	10	38.5%
Over 10,000	—	—

Notes: 1. Number responding to question.
2. Number responding with a percentage.
3. Average of percentages provided by respondents.

80

	Responses	Percent	Responses	Average %
4. WHAT PERCENTAGE OF ASSETS CURRENTLY MANAGED IS SUBJECT TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)?	25	100.0%		
Less than 25%	8	32.0%		
26%—50%	8	32.0%		
51%—75%	8	32.0%		
Over 75%	1	4.0%		
5. OF THE TOTAL ASSETS MANAGED, WHAT AMOUNT IS CURRENTLY INVESTED IN COMMON STOCKS?	26	100.0%		
Less than 25%	3	11.5%		
26%—50%	9	34.6%		
51%—75%	11	42.3%		
Over 75%	3	11.5%		
6. WHAT PERCENTAGE OF THESE COMMON STOCK HOLDINGS WOULD YOU ESTIMATE IS INVESTED IN THE FOLLOWING TYPES OF EQUITY SECURITIES?	25	100.0%		
Listed on NYSE	25	100.0%		87.32%
25% or less			1	19.00%
26%—50%			—	—
51%—75%			1	60.00%
Over 75%			23	91.47%
Listed on AMEX	19	76.0%		5.47%
25% or less			18	4.11%
26%—50%			1	30.00%
51%—75%			—	—
Over 75%			—	—
Listed on Regional Exchanges	4	16.0%		1.75%
25% or less			4	1.75%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—NASDAQ	21	84.0%		8.19%
25% or less			20	6.85%
26%—50%			1	35.00%
51%—75%			—	—
Over 75%			—	—
OTC—Non-NASDAQ	3	12.0%		8.33%
25% or less			3	8.33%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—No Public Market	1	4.0%		10.00%
25% or less			1	10.00%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
7. WHAT PERCENTAGE OF NEW MONEY RECEIVED IN 1978 HAS BEEN INVESTED IN EQUITY SECURITIES?	26	100.0%		
Less than 25%	2	7.7%		
25%—50%	12	46.2%		
51%—75%	9	34.6%		
Over 75%	3	11.5%		

	Responses	Percent
8. DO YOU HAVE ANY POLICY, EITHER FORMAL OR INFORMAL WHICH REQUIRES A MINIMUM LEVEL OF MARKET CAPITALIZATION FOR COMPANIES IN WHICH YOU INVEST?	25	100.0%
Yes	18	72.0%
Formal Policy	3	12.0%
Informal Policy	15	60.0%
No Policy	7	28.0%
9. IF YOUR RESPONSE TO QUESTION NO. 8 WAS "YES," WHAT IS THE MINIMUM MARKET CAPITALIZATION STANDARD YOUR ORGANIZATION HAS ESTABLISHED (IN MILLIONS OF DOLLARS)?	19	100.0%
Under 10	—	—
10—25	4	21.1%
26—50	4	21.1%
51—100	4	21.1%
101—250	6	31.6%
251—500	1	5.3%
Over 500	—	—

10. IF YOU *DO NOT* INVEST IN COMPANIES WITH A CAPITALIZATION OF LESS THAN $50 MILLION, PLEASE INDICATE THE REASONS FOR SUCH BY RANKING THEM FROM "MOST IMPORTANT" (1) TO "LEAST IMPORTANT" (8), AS APPLICABLE.

3.45	ERISA Concerns [4]
2.92	Price Volatility
1.71	Lack of Liquidity
4.50	Difficulty in Valuation
5.00	Lack of Financial History
3.30	Lack of Independent Research
4.75	Cost of In-House Research
1.50	Other

	Responses	Percent
11. WOULD YOU FAVOR A CHANGE IN ERISA OR IN THE ADMINISTRATION THEREOF TO ENCOURAGE INVESTMENT IN SMALL COMPANIES (I.E., SECURITIES WHICH ARE PRESENTLY EXCLUDED FROM YOUR UNIVERSE OF INVESTMENT TO THE EXTENT ERISA IS A FACTOR)?	26	100.0%
Yes	12	46.2%
No	5	19.2%
No Opinion	9	34.6%
12. IF YOUR RESPONSE TO QUESTION NO. 11 was "YES," DO YOU FAVOR EITHER OF THE FOLLOWING?		
Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."	13	100.0%
Yes	10	76.9%
No	3	23.1%

Note 4: Mean ranking given by respondents.

	Responses	Percent
Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration	8	100.0%
Yes	6	75.0%
No	2	25.0%
13. WHAT OTHER INCENTIVES, IF ANY, DO YOU FAVOR TO ENCOURAGE SMALL BUSINESS INVESTMENT?	25	100.0%
Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses	9	36.0%
Legislation to provide additional capital gains tax relief	20	80.0%
Other	4	16.0%
None	—	—
No Opinion	3	12.0%

SPECIAL SURVEY OF
INSTITUTIONAL INVESTORS & PROFESSIONAL PORTFOLIO MANAGERS
RESULTS FOR COLLEGE ENDOWMENT FUNDS

24 Surveys Tabulated

	Responses[1]	Percent	Responses[2]	Average %[3]
1. WHAT IS THE NATURE OF YOUR OPERATION?				
Bank Trust Department	—	—		
Insurance Company	—	—		
Investment Company/Mutual Fund	—	—		
Independent Money Manager	—	—		
College Endowment Fund	24	100.0%		
Other	1	4.2%		
2. WHAT ARE THE SOURCES AND PERCENTAGES OF INVESTMENT FUNDS MANAGED?	23	100.0%		
Pension Plans	—	—	—	—
25% or less				
26%—50%				
51%—75%				
Over 75%				
Institutions (Universities, etc.)	19	82.6%	19	98.94%
25% or less			—	—
26%—50%			—	—
51%—75%			—	—
Over 75%			19	98.94%
Individuals	3	13.0%	3	73.33%
25% or less			1	20.00%
26%—50%			—	—
51%—75%			—	—
Over 75%			2	100.00%
Other	2	8.7%	2	100.00%
25% or less			—	—
26%—50%			—	—
51%—75%			—	—
Over 75%			2	100.00%
3. WHAT IS THE APPROXIMATE DOLLAR VALUE OF ASSETS CURRENTLY MANAGED (IN MILLIONS OF DOLLARS)?	23	100.0%		
Under 25	8	34.8%		
25—50	4	17.4%		
51—100	3	13.0%		
101—250	4	17.4%		
251—500	1	4.3%		
501—1000	1	4.3%		
1000—10,000	2	8.7%		
Over 10,000	—	—		

Notes: 1. Number responding to question.
2. Number responding with a percentage.
3. Average of percentages provided by respondents.

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	Responses	Percent	Responses	Average %
4. WHAT PERCENTAGE OF ASSETS CURRENTLY MANAGED IS SUBJECT TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)?	19	100.0%		
Less than 25%	19	100.0%		
26%—50%	—	—		
51%—75%	—	—		
Over 75%	—	—		
5. OF THE TOTAL ASSETS MANAGED, WHAT AMOUNT IS CURRENTLY INVESTED IN COMMON STOCKS?	24	100.0%		
Less than 25%	5	20.8%		
26%—50%	9	37.5%		
51%—75%	8	33.3%		
Over 75%	2	8.3%		
6. WHAT PERCENTAGE OF THESE COMMON STOCK HOLDINGS WOULD YOU ESTIMATE IS INVESTED IN THE FOLLOWING TYPES OF EQUITY SECURITIES?	22	100.0%		
Listed on NYSE	22	100.0%		93.63%
25% or less			—	—
26%—50%			—	—
51%—75%			—	—
Over 75%			22	93.63%
Listed on AMEX	12	54.5%		6.41%
25% or less			12	6.41%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
Listed on Regional Exchanges	3	13.6%		2.00%
25% or less			3	2.00%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—NASDAQ	12	54.5%		4.58%
25% or less			12	4.58%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—Non-NASDAQ	—	—	—	—
25% or less			—	—
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—No Public Market	2	9.1%		1.00%
25% or less			2	1.00%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
7. WHAT PERCENTAGE OF NEW MONEY RECEIVED IN 1978 HAS BEEN INVESTED IN EQUITY SECURITIES?	24	100.0%		
Less than 25%	10	41.7%		
25%—50%	14	16.7%		
51%—75%	7	29.2%		
Over 75%	3	12.5%		

	Responses	Percent
8. DO YOU HAVE ANY POLICY, EITHER FORMAL OR INFORMAL WHICH REQUIRES A MINIMUM LEVEL OF MARKET CAPITALIZATION FOR COMPANIES IN WHICH YOU INVEST?	24	100.0%
Yes	7	29.2%
Formal Policy	4	16.7%
Informal Policy	2	8.3%
No Policy	17	70.8%
9. IF YOUR RESPONSE TO QUESTION NO. 8 WAS "YES," WHAT IS THE MINIMUM MARKET CAPITALIZATION STANDARD YOUR ORGANIZATION HAS ESTABLISHED (IN MILLIONS OF DOLLARS)?	7	100.0%
Under 10	—	—
10—25	1	14.3%
26—50	4	57.1%
51—100	—	—
101—250	1	14.3%
251—500	1	14.3%
Over 500	—	—

10. IF YOU *DO NOT* INVEST IN COMPANIES WITH A CAPITALIZATION OF LESS THAN $50 MILLION, PLEASE INDICATE THE REASONS FOR SUCH BY RANKING THEM FROM "MOST IMPORTANT" (1) TO "LEAST IMPORTANT" (8), AS APPLICABLE.

6.50	ERISA Concerns [4]
4.00	Price Volatility
1.56	Lack of Liquidity
3.63	Difficulty in Valuation
2.67	Lack of Financial History
3.50	Lack of Independent Research
4.29	Cost of In-House Research
4.50	Other

	Responses	Percent
11. WOULD YOU FAVOR A CHANGE IN ERISA OR IN THE ADMINISTRATION THEREOF TO ENCOURAGE INVESTMENT IN SMALL COMPANIES (I.E., SECURITIES WHICH ARE PRESENTLY EXCLUDED FROM YOUR UNIVERSE OF INVESTMENT TO THE EXTENT ERISA IS A FACTOR)?	21	100.0%
Yes	2	9.5%
No	2	9.5%
No Opinion	17	81.0%
12. IF YOUR RESPONSE TO QUESTION NO. 11 was "YES," DO YOU FAVOR EITHER OF THE FOLLOWING?		
Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."	3	100.0%
Yes	2	66.7%
No	1	33.3%

Note 4: Mean ranking given by respondents.

	Responses	Percent
Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration	2	100.0%
Yes	2	100.0%
No	—	—
13. WHAT OTHER INCENTIVES, IF ANY, DO YOU FAVOR TO ENCOURAGE SMALL BUSINESS INVESTMENT?	23	100.0%
Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses	5	21.7%
Legislation to provide additional capital gains tax relief	5	21.7%
Other	2	8.7%
None	1	4.3%
No Opinion	13	56.5%

SPECIAL SURVEY OF INSTITUTIONAL INVESTORS AND PROFESSIONAL PORTFOLIO MANAGERS RESULTS FOR "OTHER"

13 Surveys Tabulated

	Responses[1]	Percent	Responses[2]	Average %[3]
1. WHAT IS THE NATURE OF YOUR OPERATION?				
Bank Trust Department	—	—		
Insurance Company	4	30.8%		
Investment Company/Mutual Fund	2	15.4%		
Independent Money Manager	—	—		
College Endowment Fund	1	7.7%		
Other	13	100.0%		
2. WHAT ARE THE SOURCES AND PERCENTAGES OF INVESTMENT FUNDS MANAGED?	13	100.0%		
Pension Plans	8	61.5%	7	44.57%
25% or less			4	10.50%
26%—50%			—	—
51%—75%			—	—
Over 75%			3	90.00%
Institutions (Universities, etc.)	5	38.5%	5	61.00%
25% or less			1	8.00%
26%—50%			1	30.00%
51%—75%			1	72.00%
Over 75%			2	97.50%
Individuals	7	53.8%	7	54.28%
25% or less			3	12.66%
26%—50%			1	50.00%
51%—75%			—	—
Over 75%			3	97.30%
Other	4	30.8%	3	67.30%
25% or less			1	2.00%
26%—50%			—	—
51%—75%			—	—
Over 75%			2	100.00%
3. WHAT IS THE APPROXIMATE DOLLAR VALUE OF ASSETS CURRENTLY MANAGED (IN MILLIONS OF DOLLARS)?	13	100.0%	3	
Under 25	3	23.1%		
25—50	1	7.7%		
51—100	2	15.4%		
101—250	2	15.4%		
251—500	—	—		
501—1000	1	7.7%		
1000—10,000	4	30.8%		
Over 10,000	—	—		

Notes: 1. Number responding to question.
2. Number responding with a percentage.
3. Average of percentages provided by respondents.

	Responses	Percent	Responses	Average %
4. WHAT PERCENTAGE OF ASSETS CURRENTLY MANAGED IS SUBJECT TO EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)?	13	100.0%		
Less than 25%	8	61.5%		
26%—50%	2	15.4%		
51%—75%	—	—		
Over 75%	3	23.1%		
5. OF THE TOTAL ASSETS MANAGED, WHAT AMOUNT IS CURRENTLY INVESTED IN COMMON STOCKS?	13	100.0%		
Less than 25%	6	46.2%		
26%—50%	2	15.4%		
51%—75%	3	23.1%		
Over 75%	2	15.4%		
6. WHAT PERCENTAGE OF THESE COMMON STOCK HOLDINGS WOULD YOU ESTIMATE IS INVESTED IN THE FOLLOWING TYPES OF EQUITY SECURITIES?	13	100.0%		
Listed on NYSE	12	92.3%		77.91%
25% or less			1	3.00%
26%—50%			1	50.00%
51%—75%			2	65.00%
Over 75%			8	94.00%
Listed on AMEX	9	69.2%		5.44%
25% or less			9	5.44%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
Listed on Regional Exchanges	1	7.7%		5.00%
25% or less			1	5.00%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—NASDAQ	10	76.9%		11.10%
25% or less			9	6.77%
26%—50%			1	50.00%
51%—75%			—	—
Over 75%			—	—
OTC—Non-NASDAQ	3	23.1%		2.33%
25% or less			3	2.33%
26%—50%			—	—
51%—75%			—	—
Over 75%			—	—
OTC—No Public Market	2	15.4%		96.50%
25% or less			—	—
26%—50%			—	—
51%—75%			—	—
Over 75%			2	96.50%
7. WHAT PERCENTAGE OF NEW MONEY RECEIVED IN 1978 HAS BEEN INVESTED IN EQUITY SECURITIES?	13	100.0%		
Less than 25%	5	38.5%		
25%—50%	3	23.1%		
51%—75%	2	15.4%		
Over 75%	3	23.1%		

	Responses	Percent
8. DO YOU HAVE ANY POLICY, EITHER FORMAL OR INFORMAL WHICH REQUIRES A MINIMUM LEVEL OF MARKET CAPITALIZATION FOR COMPANIES IN WHICH YOU INVEST?	13	100.0%
Yes	9	69.2%
Formal Policy	3	23.1%
Informal Policy	6	46.2%
No Policy	4	30.8%
9. IF YOUR RESPONSE TO QUESTION NO. 8 WAS "YES," WHAT IS THE MINIMUM MARKET CAPITALIZATION STANDARD YOUR ORGANIZATION HAS ESTABLISHED (IN MILLIONS OF DOLLARS)?	9	100.0%
Under 10	1	11.1%
10—25	1	11.1%
26—50	1	11.1%
51—100	—	—
101—250	3	33.3%
251—500	2	22.2%
Over 500	1	11.1%

10. IF YOU *DO NOT* INVEST IN COMPANIES WITH A CAPITALIZATION OF LESS THAN $50 MILLION, PLEASE INDICATE THE REASONS FOR SUCH BY RANKING THEM FROM "MOST IMPORTANT" (1) TO "LEAST IMPORTANT" (8), AS APPLICABLE.

3.80	ERISA Concerns[4]
5.00	Price Volatility
1.00	Lack of Liquidity
5.00	Difficulty in Valuation
4.25	Lack of Financial History
3.00	Lack of Independent Research
3.20	Cost of In-House Research
1.00	Other

	Responses	Percent
11. WOULD YOU FAVOR A CHANGE IN ERISA OR IN THE ADMINISTRATION THEREOF TO ENCOURAGE INVESTMENT IN SMALL COMPANIES (I.E., SECURITIES WHICH ARE PRESENTLY EXCLUDED FROM YOUR UNIVERSE OF INVESTMENT TO THE EXTENT ERISA IS A FACTOR)?	13	100.0%
Yes	8	61.5%
No	—	—
No Opinion	5	38.5%
12. IF YOUR RESPONSE TO QUESTION NO. 11 was "YES," DO YOU FAVOR EITHER OF THE FOLLOWING?		
Legislation to redefine the "prudent man rule" to allow some percentage of assets managed to be invested in the securities of small companies, e.g., a 5% "basket clause."	9	100.0%
Yes	9	100.0%
No	—	—

Note 4: Mean ranking given by respondents.

	Responses	Percent
Revision in present regulations of the Departments of Labor and Treasury relating to overall portfolio administration	6	100.0%
Yes	6	100.0%
No	—	—
13. WHAT OTHER INCENTIVES, IF ANY, DO YOU FAVOR TO ENCOURAGE SMALL BUSINESS INVESTMENT?	13	100.0%
Legislation to provide for the roll-over of capital gains tax on investments in small businesses if reinvested in other small businesses	5	38.5%
Legislation to provide additional capital gains tax relief	11	84.6%
Other	1	7.7%
None	1	7.7%
No Opinion	1	7.7%

Mr. HAMBRECHT. In its report, our committee concluded that small businesses face an uncertain future unless barriers to investment in these enterprises are eliminated. To that end, the committee made a number of recommendations, most of which were directed to the Congress and many of which concerned taxation. Several of these recommendations have been incorporated into legislative initiatives which are currently pending before this Senate committee.

Today, I would like to focus attention on four of those initiatives.

S. 653, the Small Business Capital Preservation Act of 1979;

S. 1967, the Capital Formation Incentive Act of 1979;

S. 2168, the Subchapter S. Capital Formation Act of 1979; and

S. 2239, Incentive Stock Options.

An appropriate staring point for this discussion is the Revenue Act of 1978 which the President signed into law on November 7, 1978. One of the key features of that legislation was the reduction it provided, effective November 1, 1978, in the rate of tax imposed on capital gains. Under that new law, the maximum rate of regular income tax on net long-term gains was reduced to 28 percent. This was an excellent first step.

In terms of equity markets for small business, it had the following effects:

It has facilitated a recovery in the new issue market in terms of the number of securities offerings brought to market and the amounts of moneys raised; and it has brought about an increase in the amount of new venture capital coming into the marketplace.

In 1979, a total of 81 companies went public for the first time, raising a total of $506 million. Although this amount was nowhere near the $2.6 billion raised in 1969, it was more than double the amount raised in 1978 and more than triple the amount raised in 1977. 1979 was also an incredible year when contrasted against 1975 when a grand total of four companies were able to raise a mere $16 million.

In 1977, 1978 and 1979, venture capital groups raised total new funds of $20.2 million, $215.8 million and $175 million respectively. During this same period, small business investment companies raised a total of $100 million giving rise to possible leverage of another $360 million in financing.

Banks and other nonfinancial corporations added another $400 million during this same period. This same $1.25 billion added some $1 billion, after adjustment for followon replacement funding and withdrawals, to the estimated venture capital pool of $2.5 to $3 billion, an amount which had remained static since 1969. Entering 1980, it appears that $400 to $500 million is being sought by different venture capital groups.

Senator BYRD. Do you attribute a great deal of that to change of the capital gains tax?

Mr. HAMBRECHT. Senator, it is very difficult to quantify that specifically, and a lot of the money has come in from institutional sources that are not taxed.

Clearly though, the reduction in capital gains rates changed the psychology of investing and has brought a lot of people back to looking for long-term capital gains as an investment objective, where before the act, it had lost favor.

It is difficult to quantify. We are trying to, and hoping over the next few years to be able to develop some very hard data to prove it.

Senator BYRD. Thank you.

Mr. HAMBRECHT. In connection with the above, it is important to note that most of the activity in the new issue and venture capital markets has been directed toward the high technology, fast-growth companies. What has failed to materialize, however, is broad-based support for small, developing companies outside of the high technology field.

If small, developing companies of all types and sizes are to have equal access to the equity capital markets, more must be done on both a long- and short-range basis to stimulate investment in small business. Our NASD Committee believes that enactment of the following four bills would greatly enhance the ability of small business to raise capital and, in so doing, strengthen this country's economic foundations.

I would summarize our position on these four bills.

The first bill, S. 653, essentially the rollover provision. We feel that this would have a tremendous effect on the ability of small companies to raise money. Mr. Chairman, as you pointed out in your opening remarks, there is a dangerous trend toward mergers and acquisitions of small companies by large companies and, unfortunately, present tax laws encourage those who own an interest in a small business to sell out to large companies because the acquiring company may exchange a stock for the stock of a small business.

This entire transaction is tax free under present law.

The small businessman who sells his business is only taxed if he sells that stock at a subsequent time.

While we feel that losing the small companies to big companies is a fact of life, a deplorable fact of life but it is happening, a tax rollover would encourage that successful investor to take the proceeds of the sale and reinvest the capital back into small business.

So even though you have lost the company, at least you have kept that capital available to small business. I think that there are numerous precedents for this sort of tax thing. The utmost obvious example is home ownership.

The person who sells his home is allowed to reinvest in another home, and that, perhaps, has been one of the most powerful incentives for homeownership in the United States. We think the same thing would hold true with small business.

Next, S. 1967, Capital Formation Act of 1979. This bill would allow security market makers to defer gains from the market making activities on behalf of small business.

In our report, we did a survey of institutional investors and public investors and found that one of the greatest concerns on the part of investors was a lack of liquidity, lack of market makers, for small securities, and many institutions we found had absolute prohibitions against buying small securities because of the lack of market makers.

At the same time, we found during the past 10 years that there has been a tremendous concentration of broker-dealers in this country today. The merger movement that we talked about before has affected the securities business and many of the small, local broker-dealers have merged, or sold out, to large, New York firms.

We feel that this has caused a lack of underwriters and a lack of market makers for the small, local businesses throughout the country today.

This bill would allow a small broker-dealer to reserve up to $1 million of profits from trading and underwriting against the inevitable cyclical losses that he must take in bad years. It is particularly appropriate to discuss this today after the market we have experienced for the past 7 weeks. I think last year was generally a good year for the underwriting and market making community and yet I would guess in the last 7 weeks that many firms probably had all of last year's profits wiped out. But because they are not allowed to reserve any of these profits, they will have to report those profits last year, pay taxes in March, and yet have a financial condition seriously weakened by what has happened in the marketplace today.

Senator BYRD. What has been the basic reason for the loss the first 3 months of this year?

Mr. HAMBRECHT. That is a difficult question. Clearly there has been a lack of confidence to the country's ability to stop the inflation rate. This has had a big effect. Of course, the Federal Reserve's moves to tighten money and raise interest rates have made equity investing less attractive to investors.

I guess yesterday and the last couple of days, the market has been badly hit by the speculative scare in the silver market, so I think it points out that there are many circumstances in the marketplace that the broker-dealer has no control over that can seriously weaken his financial condition and make it much more attractive for him to seek refuge with a big firm as opposed to staying independent and leaving his own capital at risk.

We feel that this type of reserve is very similar to a bad loan reserve that any of the banks use. In the long run, it will allow a broker-dealer to smooth out the cyclical nature of his business.

Senator BYRD. Do you feel that keeping the bad loan reserves should be made for all corporations?

Mr. HAMBRECHT. I think if any business has a certain cyclicality to it, and if there is a way of showing that, indeed there are losses and real losses against a certain activity. Yes, I think that it makes sense.

In the long run, the Treasury ends up with the same revenue because it gets its profit in 1 year and the loss in another. But I think that the whipsaw effect of profit and loss on a small company would be tragic. The small entrepreneur does not have the capital resources to bolster his situation when business is bad and unfortunately, we are all human and when business is good there is a tendency to spend some of that money.

So I think this would greatly enhance an individual entrepreneur's ability to stay in business, which we think is absolutely necessarily to the capital formation process for small businesses.

We point out in our report that the large New York firms have no economic incentives to do this sort of business. All the economic incentives in the security business point to large offerings for large companies and historically the financing for small companies have come from the small, local, broker dealers who, over the years, has provided this kind of financing.

We think that is a function that has broken down over the last 10 years and the primary reason why equity has not flowed to small business.

The third bill, the subchapter S, Capital Formation Act of 1979. We feel this is extremely important because, despite all the new venture capital that has been raised over the last 3 years, most of it has come from institutions. Most of it is run by professional managers, and these gentlemen are reasonably adverse to the risk of a startup.

In our mind, the most obvious and best qualified investor for startup is an individual. What this bill would do, it would allow 100 people to join together to put up money on a risk basis to start a company instead of the present law that only allows 15.

We live in inflationary times. Ten years ago it was not uncommon for a good, solid small business to start with $200,000. Today you very seldom see a business that can start up in any size at all with any scope for less than $1 or $2 million.

So this would allow that entrepreneur to spread that risk among 100 people.

The subchapter S law allows the passing of the tax loss to the investor and we think that this makes a great deal of sense. It is a great incentive for an individual who puts his money up at risk. There is no tax gimmick here. This is real economic loss.

Again, from a Treasury point of view, the tax loss will be applied in the future if it is not used in a subchapter S situation, will be used against future profits. Again, it may defer revenue, but it does not eliminate it.

The fourth bill, S. 2239, incentive stock options. We feel one of the great incentives that professional managers have to join small companies is the opportunity to acquire an equity position in a small, emerging company. When qualified stock option plans were allowed, this was a great attraction and allowed a lot of small companies who could not compete in the wage market and did not have the money to pay the kind of wages that the big companies pay, they could still compete for successful professional managers with this equity.

Since the abolition of the qualified stock option plan, frankly, the nonqualified plan has created many, many horror stories. Many people have been hurt financially and, frankly, it has gotten a very bad reputation and, as a matter of fact, it hurts companies now when they try to acquire good professional management.

We think that this bill will go a long way to solving that problem.

Thank you, Mr. Chairman.

Senator BYRD. Thank you.

I have a number of questions but I want to ask this same question to all of the witnesses today, to each of them. Let me start with Mr. West.

The recommendations of the White House Conference on small business are many and in looking over them, I personally favor very many of them. But as a practical matter, it will not be feasible, I do not think—certainly not to enact them all—and probably only a small percentage would be approved by the Congress.

My question is, what three changes in the tax laws would be of the most importance and if you could list those three in order of importance.

Mr. WEST. Well, I think that the capital recovery, that that is probably the most important, whatever form it may come in. That particular thing is probably the most important.

Beyond that, of course, tax rate reduction would be of tremendous help. I think that, too, is important.

The third thing, as far as our particular group is concerned would be the question of the investment credit on used machinery. That is extended out beyond the present.

Mr. HAHN. I might add those 15 top options of the White House Conference were in descending order of importance when they counted the votes. No. 1 got the most votes, No. 2 the second most, and so on.

So they are in descending order as they have been presented.

Senator BYRD. That was the judgment of the Conference?

Mr. HAHN. Of the 650 members of the Conference.

Senator BYRD. No. 3 on the entire list, No. 3 in importance, is balance the Federal budget by statute in 1981 by limiting total Federal spending to a percentage of GNP commencing with 20 percent and declining to 15 percent.

I commend the members of that Conference for that recommendation. I think they are totally correct.

Until we get the Federal spending under control, I do not think it is going to be possible to solve some of these other problems and Federal spending is totally out of control.

Now, when it says balance the Federal budget by statute in 1981, I want to point out that there is a statute mandating a balanced budget for 1981. I introduced that proposal in the Senate. It was passed by the Senate. It was signed by the President on October 10, 1978. It is now a part of section 7 of Public Law 95-435.

So the statute is there. The problem is, will the President and the Congress adhere to the statute?

I think the statute has served a very important purpose because it has put the President and the Congress both in the position now of either disregarding the law and that is a little awkward, I would think, if the Congress and the President expect individuals to obey the multitude of laws that we have, or either the Congress and the President must obey the law, and balance the budget, or it must disregard the law, or it must seek repeal of the law.

And I would be most interested to see a rollcall vote in the Senate and the House of Representatives of who, today, wants to repeal the law to balance the budget.

So I think that section 7 of Public Law 95-435 has served a very important purpose and I am pleased to see that the White House Conference on Small Business recognizes the great importance of getting Federal spending under control.

Of course, there are two ways of balancing the budget. One is to increase taxes. The other is to reduce spending.

I favor reducing spending. That is the only way to get us out of this mess that we are in financially.

Our Government has been on a very unsound basis in a financial way for so long, we are continually spending beyond our means. We have doubled the national debt in 8 years, the interest on the national debt in the budget that the Congress is working on now, is $80 billion. That is the interest on the debt, just the interest charges. To put it in perspective, interest is more than 50 percent of all the money we will spend on our entire national defense structure for the fiscal year 1981.

Mr. Hambrecht, may I ask you what your three priorities are?

Mr. HAMBRECHT. Mr. Chairman, in our testimony here, we have listed them, hopefully in order of priority and how we think they would affect the capital raising function. And we think the biggest effect would come from the rollover and then the decreasing effect from the other proposals.

I would like to point out that—let me put it this way. We agree very much with your sentiments on Government spending and we realize when we have a proposal that has a revenue impact, it is a difficult proposal to get through.

I do think it is worthwhile to point out that these four proposals we have here have very, very little impact on revenue, almost none. I do not like to talk for the Treasury, but our understanding is that their revenue studies show virtually no impact from this.

In fact, one of them, the incentive stock options, actually creates more revenue than it takes away and we do think that this sort of thing will have a very strong effect on capital formation, on the health of small business, and hopefully will redirect some of this money back into the private sector of the economy.

Senator BYRD. I understand that Mr. Mason New has a brief statement.

Mr. NEW. Thank you very much.

STATEMENT OF MASON T. NEW, MANAGING PARTNER, BRANCH, CABELL & CO., RICHMOND, VA.

Mr. NEW. Senator, I just have a statement that focuses on Senate bill 1967.

My name is Mason New and I am managing partner of Branch, Cabell & Co. of Richmond, Va. From my perspective as an active market maker, the most important of the bills we have talked about today has been the introduction of the Capital Formation and Incentive Act of 1979, which would permit market makers to place up to $1 million earned from market making activities in securities of small businesses into a 10-year, tax-deferred "profit reserve." Initiated by Senator Gaylord Nelson of Wisconsin, this bill, S. 1967, will provide additional liquidity to the equity markets for smaller companies and will produce incentives or capital investment in these companies.

Although I strongly endorse and support the main purpose of S. 1967, I must note that the proposal, as it now stands, is deficient in that it overlooks two important segments of the brokerage community—partnerships and sole proprietorships. The language of the proposal specifically provides that the "market making reserve" is available only to corporations. Even though the trend in the industry has been to incorporate, there are still a substantial number of partnerships and sole proprietorships remaining. It would be unfortunate if S. 1967 were passed without including these entities in its provisions.

We estimate that 20 to 25 percent of those firms engaged in market making activities are still partnerships or sole proprietorships.

The importance of local, regional firms to the capital raising prospects of small companies cannot be overestimated. For example, the Directorate of Economic and Policy Research, of the Securities and Exchange Commission, in conjunction with the Office of the Chief Counsel for Advocacy of the Small Business Administration recently concluded the first part of a study of the role of regional broker-dealers in the capital formation process.

Reviewing the period between January 1, 1972 and June 30, 1979, the study found that regional broker-dealers accounted for 48 percent of the $2.9 billion raised in initial public offerings but more importantly, during this same period these firms raised 73 percent of the gross proceeds from the initial public offerings of corporations with less than $10 million in annual sales.

As you can see, these firms are crucial to small companies seeking public capital. Not only are small companies benefited by the efforts of these firms but the individual investor also stands to gain because of the greater depth and liquidity provided by the market making activities of these small broker-dealers which serves the public interest as well as the public investor. Thus, any efforts, such as S. 1967, which contribute to the financial strength of these firms works also to insure the financial soundness of America's small business community and the investing public.

One major point that I would like to make is that we are really talking about a public interest here in this market making reserve bill because of volatility of the prices of securities that fall in the category of $25 million or less in equity value. The prices of those securities are tremendously volatile.

One of the reasons for that, the underlying capital that goes into supplying liquidity for those markets is very minimal now. It is a very risky business to be in.

If we are able to reserve it, the small broker dealers throughout the United States are able to reserve over a 10-year period $1 million which is directly funneled into market making activities. For these kinds of companies, the first thing that happens is more broker dealers are in there competing on a price basis. You have more capital invested, therefore, I believe that price volatility will stabilize and I think that is the benefit to the investing public as well as to small companies and small broker-dealers.

Thank you.

Senator BYRD. Thank you.

Let me ask about subchapter S. That is one of your recommendations.

How does a group of individuals accumulate capital under the subchapter S procedure?

As I understand it, whether it be 10 individuals or a hundred individuals, whatever profit that company might make would be distributed in total to the 10 or a hundred or however many there may be.

How does it retain capital for future expansion and operation?

Mr. HAMBRECHT. From a practical point of view, what happens is a company retains its subchapter S status as long as it is losing money in its early development stages of business. When it gets to the point of profitability, the practical effect has been to recapitalize as a corporation and become a permanent corporation that can then pay corporate taxes on its profit but then retain the earnings after taxes.

Senator BYRD. So subchapter S is not feasible, then, for a profitable corporation. Is that it?

Mr. HAMBRECHT. That is correct, sir. It is a technique that many companies use in their formation stages when they have to, in effect, invest a lot of money in product development and in the development of its business before they are in a position to sell the product to the public.

Senator BYRD. Let me ask you this. What is the proper definition of a small business? How do you define a small business?

Mr. HAHN. Technically by categories of the Small Business Administration and that varies, depending on the particular category of business. It can be—I am not sure these figures are correct, but as small as 25 employees in certain businesses, as large as 500 and maybe even more in some other categories of business.

Senator BYRD. What is your own view as to what should be considered a small business?

Mr. HAHN. I think that at the lower end of the scale of any industry, without trying to pick a percentage, but at the lower end, generally the structure of most industries is a few relatively larger companies at the top end and many smaller companies at the lower end.

A larger number of companies, fewer employers in between those two. The line should be drawn.

Senator BYRD. I notice when I asked for the order of priority, I do not believe any of you mentioned depreciation, a change in the depreciation.

Mr. WEST. Yes. Accelerated depreciation. That is one that we named first.

Senator BYRD. What is that?

Mr. WEST. The accelerated, the 10-5-3 or some variation of it, is what we named first.

Senator BYRD. You feel that that is quite important?

Mr. WEST. Yes.

Senator BYRD. It seems to me that a liberalization of the depreciation is probably one of the most important things that could be done to help small business. Is that in accord with what you folks feel?

Mr. HAHN. That is unquestionable. On page 5 of our testimony, it documents the age of machine tools in industrialized nations as being the oldest in the seven nations shown. There is a direct correlation between the age of machine tools in those countries and the rate at which the equipment is written off.

Senator BYRD. As I see it, the Government really is not losing any money by accelerated depreciation. Once a company takes all of its depreciation, then taxes will be increased. The Government loses only on a temporary basis. In the long run, it comes out the same.

Mr. HAHN. Or ahead, because as companies get more productive equipment, they are able to compete more effectively in a market and overseas with foreign companies that have the more favorable depreciation of this now and, as a result, according to those charts, they are buying more productive equipment.

Senator BYRD. And our tax laws are more restrictive perhaps than any industrialized country in regard to depreciation. Is that not correct?

Mr. HAHN. That is correct. In England, for example, they expense capital equipment. A few years ago in Canada they changed the depreciation method in our industry, for example, in the Detroit area over the last 4 or 5 years there arose some very effective competition out of Canadian competitors as a result of the change in the tax structure with respect to depreciation.

Senator BYRD. What is the tax structure in Canada? Is it 2 or 3 years?

Mr. HAHN. I think it is 2; 2 or 3.

Senator BYRD. You say England permits an expense of depreciation?

Mr. HAHN. Yes.

Senator BYRD. I mean a 1-year writeoff on new equipment?

Mr. HAHN. Right.

Senator BYRD. That is something new, is it not?

Mr. HAHN. Yes.

Senator BYRD. Well, thank you gentlemen very much. It has been very helpful.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 389.]

STATEMENT OF WILLIAM R. HAMBRECHT

Mr. Chairman and members of the Subcommittee, my name is William R. Hambrecht and I am a partner in the securities firm of Hambrecht & Quist located in San Francisco, California. With me today are Mason T. New, who is the managing partner of the firm, Branch, Cabell & Co., in Richmond, Virginia, and member of the Board of Governors of the National Association of Securities Dealers, Inc., (the "NASD"), and Douglas F. Parrillo, who is vice president of that same orginization.

I am appearing before you today as both a member of the broker-dealer community and as the Chairman of the Joint Industry/Government Committee on Small Business Financing, a committee created by the NASD, in the fall of 1978 to address the capital-raising problems of small business. Composed of securities industry financing experts, this Committee was assisted by representatives of the Securities Industry Association, the Securities and Exchange Commission, the Department of the Treasury the U.S. Small Business Administration, the National Association of Small Business Investment Companies, the National Venture Capital Association, the White House Conference on Small Business and the Chief Counsel to the Senate Select Committee on Small Business.

The efforts of our Joint Committee culminated in a Special Report, entitled, "Small Business Financing: The Current Environment and Suggestions for Improvement," which was presented to the U.S. Senate Select Committee on Small Business on May 22, 1979. With the Chairman's permission, I would like to submit that report for the record. In its Report, our Committee concluded that small businesses face an uncertain future unless barriers to investment in these enterprises are eliminated. To that end, the Committee made a number of recommendations, most of which were directed to the Congress and many of which concerned taxation. Several of these recommendations have been incorporated into legislative initiatives which are currently pending before this Senate Committee.

Today, I would like to focus attention on four of those initiatives:

S.653—The Small Business Capital Preservation Act of 1979;

S.1967—The Capital Formation Incentive Act of 1979;

S.2168—The Subchapter S Capital Formation Act of 1979; and

S.2239—Incentive Stock Options.

An appropriate starting point for this discussion is the Revenue Act of 1978 which the President signed into law on November 7, 1978. One of the key features of that legislation was the reduction it provided, effective November 1, 1978, in the rate of tax imposed on capital gains. Under that new law, the maximum rate of regular income tax on net long-term gains was reduced to 28 percent. This was an excellent first step. In terms of equity market for small business, it had the following effect:

It has facilitated a recovery in the new issue market in terms of the number of securities offering brought to market and the amount of monies raised; and,

It has brought about an increase in the amount of new venture capital coming into the marketplace.

In 1979 a total of 81 companies went public for the first time raising a total of \$506 million. Although this amount was nowhere near the \$2.6 million raised in 1969, it was than double the amount raised in 1978 and more than triple the amount raised in 1977. 1979 was also an incredible year when contrasted against 1975 when a grand total of four companies were able to raise a mere \$16 million.

In 1977, 1978 and 1979, venture capital groups raised total new funds of \$20.2, \$215.8 and \$175 million, respectively. During this same period, small business investment companies raised a total of \$100 million giving rise to possible leverage of another \$360 million in financing. Banks and other non-financial corporations added another \$400 million during this same period. This same \$1.25 billion added some \$1 billion, after adjustment for follow-on replacement funding and withdrawals, to the estimated venture capital pool of \$2.5 to \$3 billion, an amount which had remained static since 1969. Entering 1980, it appears that \$400 to \$500 million is being sought by different venture capital groups.

In connection with the above, it is important to note that most of the activity in the new issue and venture capital markets has been directed toward the high technology, fast, growing companies. What has failed to materialize, however, is broad-based support for small, developing companies ouside of the high technology field. If small, developing companies of all types and sizes are to have equal access to the equity capital markets, more must be done on both a long and short range basis to stimulate investment in small business. Our NASD Committee believes that enactment of the following four bills would greatly enhance the ability of small business to raise capital and, in so doing, strengthen this country's economic foundations.

S. 653—The Small Business Capital Preservation Act of 1979

During the course of its work, our Committee learned that small business is fast approaching a crossroads—one which could very well determine whether it will continue to serve America as the leading creator of jobs and innovator of technological developments. It is through the small business sector of the economy that our national goals in the areas of employment, economic betterment, opportunity for achievement and an improved quality of life can be accomplished most efficiently and effectively.

Time and time again, studies from such disparate sources as the Department of Commerce and the Massachusetts Institute Technology have confirmed the job-creating productivity and potential of small business. It is only through greater productivity and increased employment that we as a nation can hope to break out of this economic malaise in which we seem to be so deeply mired. Small business is ideally suited to meet this challenge; yet, the current tax laws have served to inhibit the inflow of capital to the small business sector by discouraging investment in it.

For example, present tax laws encourage those who own an interest in a small business to sell out to large companies because the acquiring company may exchange its stock for the stock of the small business. The entire transaction is tax free under present law. The small businessman who sells his business may defer the immediate payment of capital gains taxes until he ultimately sells the new stock he received as part of the exchange.

The number of mergers and acquisitions have increased in recent years and can be expected to continue to increase in the foreseeable future. They are a fact of life in view of the capital shortage faced by small business and in view of the need for large firms to diversify their operations in these uncertain times. One of the problems with this merger trend, however, is that the small businessman who has sold his business is discouraged by current tax laws from reinvesting the proceeds of the exchange transaction in another small business. This happens because he winds up with securities which, if he were to sell, would be subject to a maximum capital gains tax of 28 percent. As a result, this capital, which normally would find its way back to other small business investments, becomes frozen and illiquid.

To remedy this situation, our Committee believes that S. 653—The Small Business Capital Preservation Act of 1979—will go a long way towards addressing this problem. Basically, the proposal would allow anyone owning an interest in a small company with a net worth of $25 million or less to sell that interest for cash, reinvest that money in another small business and defer any capital gains tax on the sale until the proceeds are taken out of the small business and not reinvested within 18 months. The adoption of this measure would, in our view, cause capital to flow back to small companies by creating tax incentives for the small business investor to reinvest his proceeds in small companies. By allowing individuals to, in effect, "rollover" their tax liability by reinvesting gains in another business, the proposal would permit an increased number of small, local companies to expand their capital base.

S. 1967—Capital Formation Incentive Act of 1979

Recently Senator Nelson introduced S. 1967—The Capital Formation Incentive Act of 1979—a bill which closely tracks one of the principal recommendations advanced by our Committee. The bill, which would go a long way towards facilitating capital formation, would allow securities market makers to defer gains from their market making activities on behalf of small businesses. In our opinion, this bill is of critical importance, particularly as the number of securities firms engaged in risk market making continues to decline in the face of an increased need on the part of small businesses for additional sources of new capital.

In the opinion of our Committee, the adoption of a tax-deferred reserve for market makers will substantially improve the ability of small businesses to raise the funds necessary to promote their growth, particularly small, developing companies which are not considered high technology firms. In order to enhance the ability of all types of small businesses to raise equity capital, steps must be taken to improve the prospects for aftermarkets in their securities—markets with adequate depth and liquidity. It is readily apparent that an investor is not going to purchase as stock in a small business which he may not be able to sell or which he may be able to sell only at a price substantially lower than what he paid. To bring about better markets, incentives to encourage risk market making in the securities of smaller companies by existing broker-dealers and new entrants to the securities business are needed. The availability of tax-deferred reserves would provide one such incentive by giving a broker-dealer some limited form of protection against losses incurred in the performance of his market making function. The use of reserves would serve to smooth out the tax consequences which accrue to the broker-dealer community, particularly smaller broker-dealers, by recognizing the cyclical nature of the securities business. For example, last year was a good year for most market makers and underwriters. The market decline of the last seven weeks could very well have wiped out most of last year's profits and will place great financial pressure on small broker-dealers. These tax-deferred reserves would provide a much-needed cushion during periods when markets are declining and the need for a viable market making community the greatest.

On the basis of our Committee's survey of over 600 institutional investors and professional portfolio managers, we found that concern over the marketability of small business investments is a key reason why many institutional investors do not invest in smaller companies. This is a very serious problem since, as the number of individual investors continues to decline and the growing institutionalization of our equity markets continues, institutional investors must bear a critical responsibility. That is, if small business is to obtain the capital it needs to survive, it will have to depend to a much greater degree on institutional investment. Mainly due to the liquidity problem, however, institutional investors have not yet taken steps to fill that void. In our Committee's opinion, S. 1967 will serve to correct this problem by adding depth and liquidity to markets in small business issues. The bill will encourage broker-dealers to put money into the market where our survey said it is needed the most.

S. 1967 would allow market makers to place up to $1 million earned from market making activities in securities of companies with equity capital outstanding of $25,000,000 or less into a ten year, tax-deferred "profit reserve." Additions to the reserve for any one year would not be permitted to exceed 30 percent of the fair market value of average equity positions carried for such market making purposes during that year. Since the amount of money going into the reserve in any one year would be directly tied to the amount a firm invests in market making positions in smaller companies, S. 1967 is in a very real sense a long-term capital incentive. For the average firm, it would take a considerable amount of time for it to reach its maximum level. Our data also suggests that enactment of this legislation would have only a modest impact on the Treasury. From an impact study of our proposal, which was somewhat broader in scope, we found that for calendar year 1977, a total of 487 broker-dealer market makers would have bene able to defer somewhere in the vicinity of $20,000,000 in tax liabilities, or about $40,000 per firm, on gross revenues from market making in over-the-counter securities of approximately $330 million.

In connection with the above, it is important to note too that by virtue of the $1,000,000 maximum, S. 1967 would not result in a windfall to any broker-dealer, large or small. The benefits derived from S. 1967 will be directly linked to the contribution a firm makes to improving the depth and liquidity of markets. What S. 1967 will do is bring about more and bettter markets in securities of smaller issuers, particularly by smaller, local broker-dealers. These are the firms that have provided local investors and local issuers with a full range of investment services. For many local businesses that were not of interest to venture capital groups or major underwriting houses, it has been the local, regional broker-dealer that has brought them public and provided secondary markets for their securities. The contraction of the broker-dealer community since the early 1970's, a phenomenon which has not spared the local, regional firm, has hit small business the hardest since many of the large national firms do not find the sponsorship of small firms to be an economically attractive activity.

No one will benefit more from enactment of this legislation than the small company seeking public financing for the first time. At some time during its life, each new business reaches a point where, to continue to grow, it must look to outside sources for additional capital. One of the traditional methods of obtaining new funds has been a public offering of securities. The key in linking private company and public investor has been the local independent broker-dealer who brings an issue through registration and who stands ready after the public offering to make a market in the company's securities. There is a delicate relationship between issuer, investor and broker-dealer with the success of each party dependent on the other two to a large extent. Upsetting this balance in recent years has been the steady decline in the number of both broker-dealers and public investors. Fewer broker-dealers has meant, in turn, that there are fewer opportunities available to small businesses to offer their securities to the public. Small businesses have suffered accordingly with the number of new issues declining from 649 to 58 annually in the ten-year period from 1968 to 1978. Market makers, I might add, have similarly declined in number by 37 percent (to 468) in that same decade.

I believe that these statistics clearly identify the problems faced today by small business eager to raise equity capital. Unless the downward trend in the number of market makers can be reversed, small developing companies will find it increasingly more difficult to raise necessary funds. S.1967 can provide the type of incentive and stimulus which is needed to combat that trend. By allowing market makers to set aside gains from market making activities in small business issues into banking-type, tax-deferred reserves, improved markets will result. The benefits to broker-dealers in the form of a tax deferral are quite obvious. The benefits to issuers in the form of a ready market for their securities are equally as apparent. The real beneficiary of the changes proposed under this legislation is the American economy which will itself be strengthened as a result of the resurgence of the small business sector to its former level of prominence.

S. 2168—Subchapter S Capital Formation Act of 1979

I am pleased that Senator Nelson and several of his collegues in the Senate have proposed legislation to modernize the Tax Code as it pertains to Subchapter S corporations. In light of the present difficulties which start-up businesses face in terms of their ability to attract capital and their lack of resources to withstand the stress of inflation, the proposed amendments are sorely needed.

S. 2168 would make two changes in the Code which, in my opinion, will noticeably increase the number of new businesses organized under Subchapter S to finance start-up operations. As this Subcommittee is aware, the incidence of new start-up companies since the late 1969's has been few and far between. By permitting the number of shareholders to increase from 15 to 100, the bill recognizes the difficulty which small companies face in obtaining sufficient capital to keep operations going during their early years of development. Essentially, new companies must rely on the financial resources and personal borrowings of their organizers (as well as those of their immediate families and friends of the organizers) to sustain themselves until sales and earnings reach a level which is sufficient to attract venture capital or some other form of external financing.

Most venture capital is institutionally funded and generally reluctant to fund start-up ventures. The natural risk-taker for start-up companies is the individual investor.

During the early years of its existence, a start-up company is likely to experience losses of varying magnitude. In due course, and as the company becomes profitable, it carries forward these early year losses and applies them against current income. By increasing the permissible number of shareholders in a Subchapter S corporation, the tax consequence would be to encourage capital formation in small businesses since the individual investor will be encouraged to put investment funds into those businesses in exchange for a tax write-off against current income. It should be kept in mind, however, that this is not a tax gimmick. These are real economic losses that would be written off at a later date by the company itself at such time as it becomes profitable. All that would happen by virtue of this bill is that these losses would be written off sooner and by someone else, that is, the individual investor. This bill is therefore extremely important since it would improve the ability of small business to attract needed capital to finance operations and growth at the period of greatest risk.

Also, by allowing a Subchapter S corporation to issue more than a single class of stock, recognition is given to the fact that certain shareholders may desire special rights in return for risking their investment capital in a new organization. These incentives could prompt individuals who in the past have been hesitant to consider a Subchapter S undertaking to re-evaluate that position. In addition, the issuance of preferred securities could lead a Subchapter S investor to commit more funds than he otherwise would have if only a single class of stock was available. While the benefits of this particular change to the Tax Code may be more difficult to quantify than the benefits derived by increasing the number of Subchapter S shareholders, I believe nevertheless that the two amendments complement each other and are sorely needed at this time.

Adoption of S. 2168 will lead most definitely to an increase in the number of corporations organized under Subchapter S and provide those currently operating with an additional source of financing. S. 2168 should provide a welcome stimulus to the economy and, in particular, to the formation of new businesses.

S. 2239—Incentive Stock Options

Although it is crucial that small companies have access to capital markets, they must also be able to attract professional managerial talent if they are to remain competitive. The most obvious and direct method of achieving this end is to pay higher salaries than the competition. Most small companies are not, however, in a position to outbid their larger competitors. To offset this disadvantage, a number of small firms formerly offered prospective employees an interest in the business by means of stock options.

These qualified stock options, in addition to attracting new talent, also benefitted small firms in other ways. One way was a broadening of the ownership base. By means of stock options, many of the emerging, successful small companies were able to create a broad base of ownership interest among their employees at a time when their employees did not have a lot of money to invest. As a firm evolves through the various stages of development and growth, it eventually requires the skills of a professional management team. The recruitment of such persons was readily facilitated through the use of qualified stock options which thereby effectively enhanced the long-term prospects for the firm's survival.

For all intents and purposes, this avenue has been closed to small business by changes in the Tax Code in recent years. Today, for example, the employee recipient of a stock option is taxed at ordinary income rates at the time he exercises his stock option. These taxes are based on unrealized gains in that they consist of paper profits between the grant price of the option and the market price of the securities acquired. To correct this inequity, our committee recommended that the Tax Code be amended to provide that no gains be recognized by option holders at the time stock options (issued at market or fair value) are granted or exercised and that the gain on securities acquired via the exercise of a stock option be the excess of the sale price of the securities over their value at the time of grant. Further, our Committee suggested that the gains realized from the exercise of stock options should be recognized as long-term gains, rather than ordinary income, provided that the combined holding period for the option and the stock is not less than three years.

In this connection, I would like to take this opportunity to endorse S. 2239, a bill introduced by Senator Robert Packwood and co-sponsored by Senators Nelson and Cranston. The proposed legislation would create a new category of stock options called "incentive stock options" which incorporate the most important incentives and safeguards of the pre-1964 restricted stock options and the later qualified options which were eliminated in 1976. Senator Packwood's proposal tracks our Committee's recommendation in that employees would not be taxed at the time they exercise their "incentive stock option." Under the Packwood proposal, the gain, for tax purposes, would be the increase in value between grant price and sale price of securities acquired. Further, this gain would be recognized, under the Packwood bill, as a "long-term capital gain."

Unlike our Committee's recommendation, however, S. 2239 would place no limit on the size of a company eligible to grant these incentive stock options and there is an important difference with respect to the holding period of the stock and option. Whereas our recommendation called for a combined holding period of three years for both option and stock, S. 2239 would require the employee to hold the stock two years from the date the option is granted and one year after exercise. If the stock is sold within two years, ordinary income would be realized on either the gain or the spread between the option price and fair market value of the stock at exercise, whichever is less.

Far from disagreeing with these differences, we are of the view that they represent an improvement on our original recommendations and would provide an even greater opportunity for small businesses to attract necessary managerial personnel.

Members of the Subcommittee, that concludes my testimony. At this time, I would be happy to answer any questions you might have. If there are no questions, I would like to introduce Mason New, who would like to make a few brief remarks regarding S. 1967.

Thank you for your attention.

Small Business Legislative Council*

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STATEMENT OF EDWARD E. WEST JR.

ON BEHALF OF

THE SMALL BUSINESS LEGISLATIVE COUNCIL

BEFORE THE

SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT

SENATE COMMITTEE ON FINANCE

HOLDING HEARINGS ON

SMALL BUSINESS TAX MATTERS

MARCH 28, 1980

"It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise...."

(P.L. 85-536, as amended, Section 2(a), Small Business Act.)

*Of the National Small Business Association

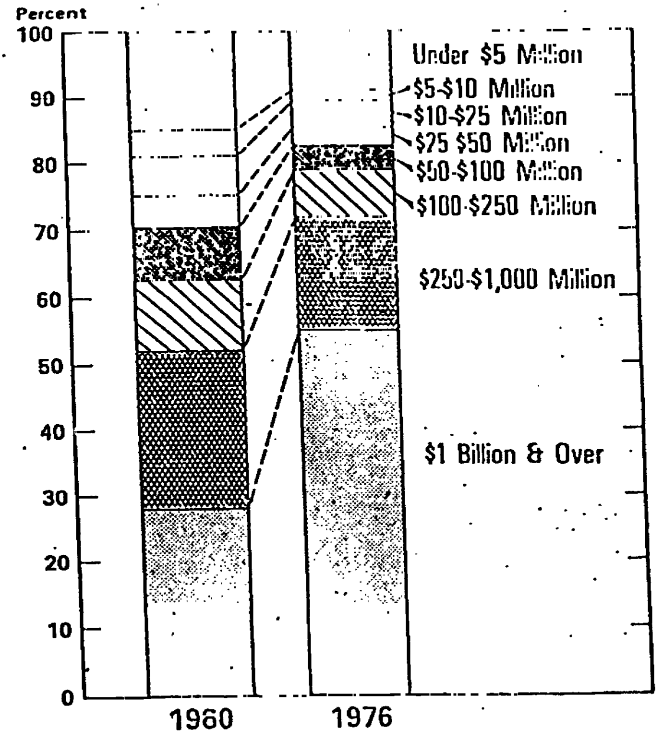
Mr. Chairman and Members of the Committee:

Good morning. My name is Edward E. West Jr. I am president of West Engineering Company, Inc., designer and builder of precision small parts, assemblies and special machines. I am appearing today on behalf of the Small Business Legislative Council and the National Tooling and Machining Association. The Small Business Legislative Council is composed of 75 associations who with their affiliates speak for more than 4,000,000 small businesses. The National Tooling and Machining Association represents 12,000 small businesses who manufacture tooling, dies, precision machined parts, molds and special machines.

We are grateful for this opportunity to discuss the capital formation problems of small business in America. The problems are great and they are aggravated even more by the current inflation and the present competition for working capital. In our industry, the problem is even greater because there is a severe shortage of skilled labor presently estimated at 14% in a February 28, 1980 industry survey.

The problem is that small businesses are typically labor intensive, highly competitive and low in profit. Despite this, they are the innovative entrepreneurs of our country. Results of studies have shown that small businesses produce ten times the innovations for the R&D dollar or compared to big business. More importantly, strength of our economic system and one of its philosophical cornerstones is that there should be an opportunity for an ambitious hard working person to enter business with some chance of success. Today, it is much harder to enter business due to the cost of capital. Once in, it is harder to stay in and to grow. In 1960, businesses with under $10 million in assets accounted for about 20% of the nation's manufacturing assets while those with over a billion in assets held less than 30%. In 1976, the former category declined to 10% while the latter increased to over 50%, and it's getting worse.

Concentration of Total Assets for Manufacturing Corporations, 1960 and 1976



Many small business industries are critical to the country's health. Our industry makes it possible for virtually every other manufacturing industry to exist. Take for example the manufacture of a carburetor. To make that carburetor, molten aluminum is injected under pressure into the cavities of an extremely complex, precise mold. Highly skilled technicians in our industry engineered and fabricated that mold. The molded carburetor body is then put on an automatic assembly line where additional machining is performed, holes drilled and parts attached. Our industry designed and built that assembly line which is in fact a special machine. We designed the jigs and fixtures which drilled the holes at just the right angles to the exact depth. And while the carburetor was being built; body parts and bumpers were being formed in dies we produced, dashboards and plastic interior parts formed in our molds, and solid state radios produced with parts made in our molds and assembled with our special machines. The major industries which depend on our small businesses are virtually endless, including aerospace, defense, electronics, appliances and most others.

There is a dangerous decline in productivity in this country and much of it is due to the fact that small business persons find it harder and harder to obtain capital to upgrade existing plant and equipment, much less to expand. In our industry, 78% of the companies have 30 employees or less. A company with 30 employees might do $ 1,500,000 in volume and make a net profit of 7% or $ 105,000. A small milling machine would have cost around $500 in the 1930's. Its modern counterpart, which is computer controlled and far more productive costs with $60,000. Many modern machine tools cost over $ 200,000.

To buy that machine tool, I would have to pay for it out of profits on retained earnings. My profits are low, partly due to depreciation rates that are unrealistic in a modern industrialized country. When I go to a bank, one of the first questions asked is the size of the company. Banks are inherently very conservative in their lending policy. The major corporations get the most money at the best rates, the smaller companies get whats left over, if any, at a much higher rate. The leftovers are getting smaller and established viable small businesses are increasingly being turned down flat. And when you add a couple of points to today's 19% prime rates, many probably couldn't afford it anyway.

There are not many other avenues for obtaining capital in small business. It is not practical to float corporate bonds, to sell corporate stocks or to use other avenues available to the industrial giants. The result, according to an article in American Machinist Magazine inserted in the Congressional Record by Senator Nelson on December 19, 1979, is that the smaller manufacturer is trading down. Just as the American housewife is buying cheaper cuts of beef, we are buying stripped down less productive equipment and buying it less often.

Today, the United States, which once had the most modern and sophisticated machine tool population in the world, now has the oldest machine tools of seven major industrialized countries. We have the lowest percentage under 10 years old and the highest percentage over 20 years old. This has dangerous implications on the national economy. Ours is the industry that supplies the tools, jigs, fixtures, molds, automatic assembly machines essential to virtually every manufacturing company in the country. The productivity of the country's entire manufacturing process is dependant upon the productivity of this industry. Yet, the country's ability to tool up for major manufacturing needs, such as a military crisis, is seriously in doubt. A major factor that enabled this country to prevail in the Second World War was the ability of our industry to gear up for massive armament production in a short period of time. Today, many other countries are far better equipped than the U.S. to cope with such emergencies.

MACHINE TOOLS IN USE IN SEVEN INDUSTRIAL NATIONS
By Number and Age
(Number in Thousands)

Country	Year	Total	Percent of Total		
			Under 10 Years	10-20 Years	Over 20 Years
United States	1976-78	2,633	31%	35%	34%
West Germany (c)	1977	1,400	37	37	26
United Kingdom	1976	891	39	37	24
Japan	1973	825 (a)	61	21	18
France (d)	1974	742	37	33	30
Italy (e)	1975	541 (b)	42	30	28
Canada	1978	211	47	35	18

(a) American Machinist, March 1973 [illegible] the total is for plants with over 100 employees only and the number of plants with less than 100 employees at large. In October 1973 American Machinist estimated the Japanese machine tool park at 1.5 million units.
(b) This total applies only to plants in the metalworking industries with 20 or more employees. The total number of machine tools in plants of all sizes in all industries is estimated to be about 540 thousand.
(c) Machine tool age classifications are as follows: Under 11 Years, 11 to 20 Years, Over 20 Years
(d) Machine tool age classifications are as follows: Under 9 Years, 9 to 19 Years, Over 19 Years
(e) Machine tool age classifications are as follows: Under 8 Years, 8-17 Years, Over 17 Years
Source: McGraw Hill, Inc. "American Machinist" and Verein Deutscher Werkzeugmaschinenfabriken e.V.

What is needed is a comprehensive strategy to encourage investment in the small business. At the White House Conference on Small Business, 2000 small business persons reduced some 75 priorities to the 15 top needs of small owners. Five of those priorities were in the area of taxation and capital formation. All five made the cut. In fact, the top two were taxation and capital formation. These proposals make sense, for small business has the greatest potential for improvement in productivity. Incentives for small business will produce the greatest increases in productivity, in innovation and in employment at the least cost in revenue loss to the U.S. Treasury.

Such a package should include an extension of the progressive corporate tax rate with corresponding reductions in the lower brackets. This is the top priority of small business in America. Senator Nelson's S2136 would extend brackets to $150,000 and reduce rates in several of those brackets. If enacted, the bill would result in about $3 billion in tax savings for smaller companies earning less than $ 150,000.

The second part of the package, and the number two priority of the 2000 delegates at the White House Conference should be to provide for a more rapid write-off of capital equipment. There are currently two proposals; the first is S1435, the 10-5-3 bill, introduced by Senator Nelson. While well intentioned, it will need an important modification if small business is to benefit from it. Its problem lies in the technique used to phase-in the benefits. To reduce the revenue loss, the authors have used a progressive phase-in based on the Asset Depreciation Range for equipment and gradually reduce taxable life for buildings and structures. The problem is that small businesses don't use ADR now due to its complexity, a fact well documented by IRS. The building phase-in also unnecessarily complicated for the relatively unsophisticated small business person.

The solution to the problem lies in an approach developed by Congressman Henry Nowak, Chairman of the Subcommittee on Access to Equity Capital and Business Capital of the House Small Business Committee. In late February he introduced HR6617, the Small Business Incentive Act of 1980. Like S1435, it reduces the write-off period for capital assets using slightly different write-off periods than the 10-5-3 bill. Where it differs is that it uses ceilings, or caps on the amounts that can be written off at the rapid rates. It uses a four-year write-off period with a $1 million ceiling for equipment machinery and vehicles and a fifteen-year write-off period with $3 million ceiling on buildings. Amounts in excess of those ceilings would be depreciated at current rates. It is simple, easy to use, and would have a much smaller impact on federal revenue than the $75 billion figure estimated by Secretary of the Treasury William Miller on the price for the 10-5-3 bill. If a phase-in method using progressive ceilings were incorporated into the 10-5-3 bill, it would then become something which could benefit the small business community.

Since 1975, the first $100,000 of used equipment purchases has been eligible for the 10% investment tax credit. Yet many capital intensive small businesses spend more times that amount on used equipment. New equipment often takes too long to get or is too expensive. SBLC believes that there should be no discrimination against the age of equipment and that all limits should be removed. S2152, introduced by Senator Nelson, would provide an interim solution by doubling to $200,000 the present limit.

As part of the package, several other pieces of legislation should also be enacted. Briefly, they are as follows:

1. The capital gains rollover bill (S653) which would allow tax deferral when a small business owner sells his firm, if the proceeds are reinvested in another small business within 18 months.
2. A tax credit for the purchaser of newly issued stock of small firms with a net worth of $25,000,000 or less (S487 and S655).
3. A bill to strenghten the financial structure of independent securities firms in order to be able to render capital raising assistance to smaller businesses (S1967).
4. A bill to raise accumulated earnings levels from the current $100,000 limit to $250,000.
5. An exemption of publicly-held venture capital firms from the regulation of the Securities and Exchange Commission under the Investment Company Act of 1940 (S1940).
6. A bill creating a new security called a Small Business Participating Debenture which would have the status of a debt security with a stated rate of interest (S1481).

7. Increasing the estate tax exemptions from a maximum of $175,625 to $250,000 by 1981 to encourage continuity of business enterprises (S1825).

8. A bill to preserve family businesses. A related proposal is the National Family Business Preservation Act of 1980 would change current estate tax laws so that up to one-half ($500,000 maximum) of the value of a family-owned business would be exempt from estate taxes (S2220).

9. Strengthen Subchapter S for capital raising purposes, by increasing the permissible number of shareholders from 15 to 100 and allowing issuance of more than one class of stocks (S2168).

10. A reinstatement of tax favored options to broaden the base of ownership in new and small firms and to provide incentives for talented executives to join such venture (S2239).

11. Elimination of the requirement to issue a W-2 form each time a worker changes jobs, allowing all the W-2's to be distributed at the end of the year (S2171).

Thank you very much for the opportunity to discuss the status of small business in America. With the help of this committee and the rest of Congress, small business may be able once again to become a strong and healthy part of the American economy.

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Small Business Legislative Council*

March 5, 1980

The position paper -- Capital Investment Recovery -- is supported, as of this date, by 48 members of the Small Business Legislative Council:

American Association of Nurserymen
Washington, D.C.

American Textile Machinery Association
Washington, D.C.

Association of Independent Corrugated Converters
Washington, D.C.

Association of Physical Fitness Centers
Bethesda, Maryland

Automotive Warehouse Distributors Association
Kansas City, Missouri

Business Advertising Council
McLean, Virginia

Christian Booksellers Association
Colorado Springs, Colorado

Direct Selling Association
Washington, D.C.

Eastern Manufacturers and Importers Exhibit, Inc.
New York, New York

Electronic Representatives Association
Chicago, Illinois

Independent Business Association of Michigan
Kalamazoo, Michigan

Independent Business Association of Washington
Bellevue, Washington

Independent Sewing Machine Dealers of America, Inc.
Hilliard, Ohio

Institute of Certified Business Counselors
Lafayette, California

International Franchise Association
Washington, D.C.

Local and Short Haul Carriers National Conference
Washington, D.C.

Machinery Dealers National Association
Silver Spring, Maryland

Manufacturers Agents National Association
Irvine, California

Menswear Retailers of America
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*Of the National Small Business Association

National Association of Brick
Distributors
McLean, Virginia

National Association of Floor
Covering Distributors
Chicago, Illinois

National Association of Plastic
Fabricators
Washington, D.C.

National Association of Plastics
Distributors
Jaffrey, N.H.

National Association of Retail Druggists
Washington, D.C.

National Beer Wholesalers Association
of America, Inc.
Falls Church, Virginia

National Burglar & Fire Alarm
Association
Washington, D.C.

National Candy Wholesalers
Association, Inc.
Washington, D.C.

National Coffee Service Association
Chicago, Illinois

National Concrete Masonry Association
Herndon, Virginia

National Electrical Contractors
Association, Inc.
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National Family Business Council
Washington, D.C.

National Home Furnishings Association
~~Washington,~~ D.C.

National Home Improvement Council
Washington, D.C.

National Independent Dairies Association
Washington, D.C.

National Office Machine Dealers
Association, Inc.
Zanesville, Ohio

National Office Products Association
Alexandria, Virginia

National Parking Association
Washington, D.C.

National Patent Council
Arlington, Virginia

National Pest Control Association
Vienna, Virginia

National Precast Concrete Association
Indianapolis, Indiana

National Small Business Association
Washington, D.C.

National Society of Public Accountants
Washington, D.C.

National Tire Dealers and Retreaders
Association
Washington, D.C.

National Tooling and Machining
Association
Washington, D.C.

National Tour Brokers Association
Lexington, Kentucky

National Wine Distributors Association
Chicago, Illinois

Power & Communication Contractors
Washington, D.C.

Sheet Metal & Air Conditioning
Contractors' National Association
Vienna, Virginia

CAPITAL INVESTMENT RECOVERY

Small business has seen its role in the U.S. economy dwindle for decades. Much of the reason for its decline lies in its inability to get the capital to be able to compete with large business in this country. The corporate giants, meanwhile, have access to the capital they need at the lowest available rates. They continue to increase their share of the Gross National Product at the expense of small business.

This competitive country must redirect its economic structure to return to the principles of private enterprise upon which it was founded. At the rate we are going there will soon be no small business in America. The American dream of starting one's own business and making it a success will be nothing more than a dream. No one man or woman will be able to come close to competing with the major corporations.

The U.S. Congress can help restore the American dream by passing legislation facilitating the recovery of capital. But it must be of genuine help for the small business and not a tool for big business to continue to take over and freeze out small business as it has been doing for years. The corporate giants, with their easy access to capital at the lowest rates, would use any legislation to accelerate expansion to the disadvantage of small business if there is not a ceiling on the benefits. The small retailer would get little joy from his newly won benefits if he found a major corporate chain was using them to open a store next door. This would happen without a ceiling. The small manufacturer would find the same thing. Whatever he was able to invest in new productive equipment would be more than matched by the well-heeled giant that had been running him out of business anyway. In some industries, major corporations who presently subcontract would find it a greater advantage to manufacture themselves should legislation without a ceiling be passed.

Any tax bill accelerating depreciation should provide a 10% investment tax credit for all equipment, machinery, and furnishings. It would allow them to be depreciated over four years. This type of capital investment could be depreciated as much as four or five times faster than presently allowed. These breaks would be targeted to small business by limiting to $1 million the amount of total investment in equipment, machinery and furnishings upon which accelerated depreciation would be allowed.

Buildings and fixtures would also be depreciated much faster. These types of investments could be written off in 10 years. This type of investment could be depreciated as much as six times faster than under present rules. This break would also be targeted to small business by limiting to $1 million per year the amount of investment in buildings and fixtures upon which accelerated depreciation would be allowed.

Over 97-1/2% of all U.S. companies would be able to use this legislation to full advantage. Most of the remaining 2-1/2% of companies, which account for 79% of the investment in this country, could use it up to the ceiling amounts. Thus this bill both would help small business and significantly reduce the revenue loss that would occur if there were no ceilings on benefits.

RESOLVED

Increased capital investment by small business is essential if this basic American institution is to survive and prosper. SBLC endorses legislation that will encourage increased capital investment by small businesses. The combined effect of more rapid depreciation and increased investment tax credit will assure small business a greater return on its investment in such capital, thereby making small business more profitable, and better able to compete in all markets.

FULL INVESTMENT TAX CREDIT FOR SMALL BUSINESS

The decline in our productivity is caused by several conditions. For the first time in twenty years, the Joint Economic Committee Annual Report of 1979 unanimously concluded that an increase in productivity is vital to the improvement of our economic standard of living and to the reduction of inflation. A partial cause of this situation is the antiquated production facilities of many American manufacturers. Another partial cause is the utilization of inefficient equipment; and yet another partial cause is the overall age of our country's industrial machinery. The most recent U.S. survey of machine tools shows only 11% of the industrial machinery in use today is less than five years old; 76% is at least ten years old. Equipment renewal and upgrading are necessary in both large and small manufacturing companies. Increasing productivity through equipment renewal is best achieved for small business through the purchase of affordable used machinery and equipment.

Under present law there is a $100,000 limitation on the amount of used equipment eligible for investment tax credit, but there is no limitation on the investment credit available for new equipment. This discriminatory tax treatment impacts directly and primarily on small business which is already hindered by its inability to externally or internally generate capital necessary to buy new equipment.

In order to increase productivity and competition, the discriminatory ceiling on the amount of used property eligible for a tax credit must be eliminated; and, the carryover provisions available for new property must also be available for similarly situated used property. Traditionally, small businesses purchase used capital equipment; large businesses basically purchase newly manufactured capital equipment. The cost of obtaining capital for production equipment is high for everyone, especially those who cannot borrow at the prime rate. Firms purchasing used capital equipment do not have a chance to offset some of their costs through this tax credit. Confining the investment credit to only equipment with the latest technology helps primarily the largest enterprises and basically ignores the largest segment of our economy which needs this tax credit the most. Because the small business sector offers the greatest potential for increasing employment, there is normally a direct relationship between increased installation of used machinery and increased employment.

RESOLVED: Small Business Legislative Council urges and supports changes in the IRS Code to allow a full investment tax credit for used machinery and equipment. This full investment tax credit will allow small businesses to receive the same tax incentive provided to big businesses and would allow small businesses to compete, to maintain their current market share, and to hopefully expand output and productivity.

INVESTMENT TAX CREDIT -- Associations supporting SBLC position 12/11 (45)

American Assn. of Nurserymen
Washington, DC

Association of Diesel Specialists
Kansas City, MO

Association of Independent Corrugated
Converters
Washington, DC

Assn. of Physical Fitness Centers
Bethesda, MD

Automotive Warehouse Distributors Assn.
Kansas City, MO

Building Service Contractors Assn. Intl.
McLean, VA

Business Advertising Council
Cincinnati, OH

Christian Booksellers Assn.
Colorado Springs, CO

Direct Selling Association
Washington, DC

Eastern Manufacturers & Importers Exhibit
New York, NY

Electronic Representatives Assn.
Chicago, IL

Independent Bakers Association
Washington, DC

Independent Business Association
of Michigan
Kalamazoo, MI

Independent Sewing Machine Dealers
of America
Hilliard, OH

International Franchise Association
Washington, DC

Local and Short Haul Carriers National
Conference
Washington, DC

Machinery Dealers Natl. Assn.
Silver Spring, MD

Manufacturers Agents Natl. Assn.
Irvine, CA

Marking Device Association
Evanston, IL

Menswear Retailers of America
Washington, DC

Minnesota Association of Commerce and
Industry Small Business Council
St. Paul, MN

Narrow Fabrics Institute
New Rochelle, NY

Natl. Assn. of Catalog Showroom Merchandisers
New York, NY

Natl. Assn. of Floor Covering Distribs.
Chicago, IL

Natl. Assn. of Plastic Fabricators
Washington, DC

National Ass. of Plastics Distributors
Jaffrey, NH

National Association of Retail Druggists
Wshington, DC

National Candy Wholesalers Association
Washington, DC

Natl. Coffee Service Assn.
Chicago, IL

Natl. Electrical Contractors Assn.
Bethesda, MD

National Family Business Council
West Bloomfield, MI

National Independent Dairies Assn.
Washington, DC

atl. Independent Meat Packers Assn.
Washington, DC

Natl. Insulation Contractors Assn.
Washington, DC

Natl. Office Machine Dealers Assn.
Zanesville, OH

National Paper Box Association
Haddonfield, NJ

National Paper Trade Association
New York, NY

National Parking Association
Washington, DC

National Pest Control Assn.
Vienna, VA

National Small Business Assn.
Washington, DC

Natl. Society of Public Accountants
Washington, DC

National Tour Brokers Assn.
Lexington, KY

Power and Communications Contractors
Association
Washington, DC

Printing Industries of America
Arlington, VA

Sheet Metal & Air Conditioning
Contractors National Association
Vienna, VA

Senator BYRD. Next there will be a panel of accountants: Mr. Joel Forster, C.P.A., Ernst and Whinney and Mr. Gerald W. Padwe, C.P.A., Touche Ross and Co.

Welcome, gentlemen. We are glad to have you.

STATEMENT OF JOEL FORSTER, C.P.A. ERNST AND WHINNEY

Mr. FORSTER. Good morning. My name is Joel M. Forster. I am a partner in the Washington, D.C., office of Ernst and Whinney where I am primarily responsible for tax policy matters.

I appreciate the opportunity to appear before you today to submit our views on certain tax reforms and capital formation proposals that we think will encourage the formation and growth of small business.

I am submitting at this time our written comments on several of the bills you indicated you wish to focus on in the announcement of these hearings and have related them to the more important recommendations and resolutions adopted by the White House Conference on Small Business. We would appreciate the inclusion of our written comments in any record of these hearings.

Senator BYRD. It will be published in the record that may be printed.

Mr. FORSTER. We believe that selective tax reduction should receive your prompt attention because it is needed now to help compensate for the impact of recent inflation and lessen the prospects for additional hardships from the Government-predicted recession that now seems to be at hand.

We also believe that great emphasis, and early priority, should be given to incentives for the private sector of our economy. It seems fundamental to us, if there is going to be any reasonable prospect of achieving the commendable goals of a balanced budget and increased productivity in the foreseeable future we need to act without further delay.

I will focus my remarks today on one major incentive for capital formation and one significant deterrent to business. They are simplified and accelerated capital cost recovery and the need for regulatory reform and a coordinated policy effort by those Government agencies charged with administering the laws that affect all businesses, both large and small.

The Capital Cost Recovery Act, S. 1435, represents a unique opportunity to introduce major reform into our tax system at a time when this special type of reform is urgently needed. While almost all economists agree that this new proposal would provide a major incentive for capital formation, the simplicity of the proposal is very impressive.

The Capital Costs Recovery Act (CCRA) would replace the concept of depreciation based on the useful life of an asset with a computation using standard cost recovery percentages. In addition, while the type of property eligible for the investment credit under the Capital Costs Recovery system would not change, the rules which make useful life a determining factor for eligibility and which relate to recapture would change.

CCRA places all assets in three categories and specifies their cost recovery over a period of either 10, 5, or 3 years. After the system is fully effective, each year's capital recovery allowance would be determined by applying a set of fixed percentages to original cost; salvage value is not considered.

In order to spur private investment, CCRA seeks to change current depreciation provisions to permit more rapid recovery of capital costs. Accelerated depreciation reform would aid businesses in obtaining a more realistic rate of recovery and would act as an incentive to productive investment and also make the United States more competitive with other countries that have already recognized the need for abandoning the useful life concept in favor of rapid capital cost recovery, Great Britain and Canada being two that we just mentioned.

The proposed capital cost recovery system in S. 1435 will meet the needs of small business for simplification of our tax law and for increased capital formation and retention. Treasury figures for 1974 show that, while the majority of larger corporate taxpayers elected to use the Asset Depreciation Range system (ADR) only 1 percent of businesses with assets of $1 million or less did so. The Capital Costs Recovery Act would correct this situation.

Small firms will save on recordkeeping and compliance costs under the new system and will have the flexibility to carry any unused capital recovery allowance forward to be deducted in future years; an important option for firms in loss positions or with widely fluctuating income from year to year.

It has been suggested that a limit, or "cap", be placed on the amount of depreciation that could be claimed under the Capital Costs Recovery Act. The purpose of this cap would be to restrict the amount of depreciation that could be claimed by larger businesses in capital intensive industries. We are opposed to the idea of a cap because it would add complication to a simple concept. Instead of eliminating or narrowing the choices, it would add to them; present methods such as straight line, declining balance, et cetera would still be available. We think that simplification is the overriding consideration for small business in this matter and therefore, we would not place a cap on CCRA unless required by budgetary considerations.

In addition, as a matter of equity, we think a capital cost recovery proposal without a cap will provide more equity. Small business will benefit along with large business, and these benefits will be proportional to their capital investment. We might also point out that sometimes there is irony in equity. The Windfall Profits Tax Act calls for 60 percent of revenues generated by that tax to be returned to taxpayers through tax reduction. Opponents of CCRA argue that it favors capital intensive industries.

Next to public utilities, the petroleum industry has the most capital invested per employee and thus it could be said that it would benefit disproportionately from CCRA. But since that industry, in a sense, will be providing the revenues which may be used to fund CCRA, there are some who would argue that equity has been served.

The Treasury continues to suggest a modification of the ADR rules as an alternative to CCRA. It would liberalize these rules by expanding the ADR ranges to 40 percent from their present 20 percent range and in addition, would reduce the narrow asset classifications. Presently, there are over 100 classifications.

However, when all is said and done, business would still have numerous depreciation methods and useful lives to deal with—a complicated system even in its new, simplified form.

Although we feel CCRA is certainly worthy of serious consideration, we are aware that some modifications may be necessary and in the best interest of our economy. The Capital Cost Recovery Act responds to the needs of the entire business community in depreciation reform and, if adopted it will encourage economic growth and modernization. Most important of all is the fact that small business will use it.

As certified public accountants, we feel that we have some responsibility to inform our clients and the public of important tax changes. Perhaps an example will give you some idea of just how important we think the concepts embodied in the Capital Costs Recovery Act are.

As a partner in my firm, I am, to a large degree, responsible for many of our firm's tax publications and I can assure you that if 10-5-3 legislation or some similar legislation were enacted, we would in all likelihood prepare a booklet explaining this new concept and distribute it to all of our clients.

On the other hand, if depreciation reform was limited only to a change in ADR rules as suggested by the Treasury, we would not be inclined to issue such a publication. Instead, we would probably inform all of our professional staff of the change and we would expect that they would convey these changes to our clients.

Primarily, this difference in treatment would result because we think that a change in the ADR rules would not be easily understood by all of our clients and would only be of interest to those with a direct involvement in taxation.

On the other hand, we believe that every businessman could understand 10-5-3 or some similar concept.

One other thing that I would like to talk about this morning is Government regulations and paperwork. One recommendation of the White House Conference has to do with Government regulations and paperwork itself. The Conference delegates recommended—and I quote: "Congress shall exercise its oversight function with the assistance of the General Accounting Office, instituting sunset reviews of all laws, regulations, and agencies, to insure that none exceeds original Congressional intent."

The key idea, I think, is that Government agencies should operate to insure that congressional intent is fulfilled. In instance after instance, I have seen what seems to be clear-cut congressional intent frustrated by the lack of a coordinated policy within the administrative agencies charged with regulating the law.

While I do not advocate the use of the tax system as a means of accomplishing social goals, the fact of the matter is that it is being used for that purpose. Congress has enacted a number of tax provisions to encourage energy conservation, environmental protection, urban redevelopment, et cetera.

The policy considerations in these matters are very broad, yet strict interpretation of the related tax issues by the Treasury Department continues to restrict congressional intent and frustrate the efforts of taxpayers to take advantage of the incentives provided by Congress.

For example, we recently had occasion to have a client call upon us to determine whether a recycling process they had developed would be eligible for the energy investment credit enacted as part of the Energy Tax Act of 1978 for the purpose of recycling solid waste. Their process was so good that it took the entire solid waste matter and returned every bit of it to usable new material.

In view of the fact that no regulations have, as yet, been issued by the Treasury Department in this area, we inquired of the Treasury Department as to whether or not the client would be entitled to claim the energy credit.

The process had the approval of the EPA in that it converted solid waste to new matter. It also had the approval of the Energy Department in that the waste products involved were made from petroleum derivatives, and therefore, recycling encouraged conservation of a natural resource. Furthermore, the energy required to recycle the product was less than the energy needed to produce a new product of equal value.

It was obvious to all involved, up to that point, that the recycling process would provide desirable environmental and energy conservation benefits.

However, the Treasury Department chose to take a somewhat more restrictive view. Its representative said that at some point in the process new raw material appeared and, from that point on, the equipment required to recycle this new material into a salable commodity would not be eligible for the energy investment credit.

So, you see, we not only have a lack of uniform Government policy but a conflict among agencies. Business, both large and small, is frustrated by this regulatory chaos and so too are the policies of Congress.

Thank you for your attention today. If we can be of assistance to you in any way regarding these matters, or any other matters in our written statement, we would be glad to make all of the resources of our firm available to you.

We have covered a number of other proposals in our written comments, including the graduated corporate tax rates, reduced maximum personal income tax rates, Government-mandated capital costs, small business reinvestment incentives, subchapter S corporations, and the paperwork burdens.

Senator BYRD. Thank you, Mr. Forster. It was helpful testimony. Our next witness?

STATEMENT OF GERALD W. PADWE, C.P.A., TOUCHE ROSS & CO.

Mr. PADWE. Senator Byrd, thank you very much.

I am Gerald W. Padwe, associate national director of tax services for Touche Ross & Co. I am most grateful for the opportunity to appear before you to present my firm's views on various tax matters of interest to small business.

We have prepared a rather comprehensive statement on the subjects I am going to cover this morning, and I am going to pick and choose from among those subjects in our written statement in the interests of time.

Senator BYRD. That is good, and your entire statement will be inserted in the record.

Mr. PADWE. I appreciate that, Senator Byrd.

Our major points are twofold, the first goes right to the problem you were raising with the last panel, Mr. Chairman. We believe that much can be done for small business without recourse to additional legislation—and I am dealing here primarily with the tax area—but we believe that the perceived attitude on the part of our tax administrators, the Treasury Department, and the Internal Revenue Service is such that they are constantly seeming to throw roadblocks in the way of small business and its abilities to pursue a normal profit orientation.

This is not a conscious bias, Mr. Chairman, but we suggest that, in their attempt to curb potential abuses and to protect the revenues to fund Government programs, our administrators probably go beyond what is necessary; and small business often bears the brunt of their decisions disproportionately, not Washington staffs of representatives to communicate between Government and the small business person directly.

We have given several examples of our attitude problems in our written testimony; let me just go through one or two of them here and then turn to specific things that we would like to see you and your committee consider with respect to legislation.

Certainly one of the greatest inflation hedges available today in the tax law is the ability of a business to use the LIFO method of inventory. I do not want to get into the details of LIFO computations here, but suffice it to say that while the Code section is very short, the regulations and rulings are extremely complex.

Unfortunately, too many small businesses do not adopt LIFO because its complexity and its costs—the complexity of the regulations, the cost of conversion to LIFO, and the cost of maintaining LIFO in terms of recordkeeping, statistical sampling, and so forth—become almost prohibitive from a small business point of view, given the benefits to be derived.

We have found that some of our small business clients trying to adopt LIFO either cannot do it due to the expenses involved, or find that they will have to bend the rules and the regulations, thus subjecting them to the possibility of the Internal Revenue Service, throwing them off the method when their tax returns are examined.

The IRS approach to encouraging business to adopt LIFO has hardly been an enthusiastic one. In fact, their training manual on LIFO inventory contains this sentence, "It is *inevitable* that an agent will become involved in an examination of a LIFO taxpayer's return that will *require* the agent to terminate the use of the LIFO method." (Our emphasis.)

One of the problems with LIFO is that the larger the number of items in inventory, the more complex it becomes because of the need to double price each of these items, using both base year prices and current year prices. Sampling is permitted, but the cost of sampling or the cost of the methodology involved in developing a statistical sample, as I said, can be virtually prohibitive for the small business.

The use of general and simple indexes to avoid voluminous double pricing is technically permitted, but a published IRS ruling states that unless the taxpayer provides convincing proof that the specific index is applicable to his specific inventory, it will not be allowed (revenue ruling 75-181).

The one exception in general use today, concerning utilization of indexes, applies to retail department stores and certain specialty stores. Here the Bureau of Labor Statistics provides a semiannual index which is accepted by the Internal Revenue Service—and, by the way, the cost of providing that index is borne by the department store industry, not by the Government.

We are aware of efforts on the part, however, of other industries, to develop an acceptable index; for example, retail grocers. While there are large grocery chains in the industry, there are also a tremendous number of small business retail grocers. Retail druggists are another group seeking to have special indexes approved for them.

However, the grocers have been in negotiation with IRS and the Bureau of Labor Statistics now for 5 years without an index being forthcoming. The druggists, too, have been negotiating unsuccessfully, but for a shorter period of time. Still, the "roadblock" approach is just incredible.

Senator BYRD. What is the Treasury's objection to LIFO?

Mr. PADWE. I am not sure. It could be a revenue matter.

Senator BYRD. Explain why it would be a revenue matter.

Mr. PADWE. Senator Byrd, if LIFO inventory is adopted, the bottom line effect is to defer—perhaps for long periods of time—the tax on inflation in inventory.

LIFO has been permitted in the Internal Revenue Code since 1939, but it only has become truly popular in the past number of years as inflation rates have soared. Large businesses do use LIFO very much today.

Senator BYRD. Over a period of a few years, does it not average out?

Mr. PADWE. That depends. If your inventory keeps growing, or if prices keep going up—and certainly the latter is occurring now—you continue to get the deferral and, of course, there is the use of money concept.

Treasury would rather collect $1 today than collect $1 in 10 years. They have the use of the money for 10 years, and the dollar they collect 10 years from now will not be worth as much as the dollar they collect today. So I think there is a revenue impact.

We would like to know why Treasury or IRS does not allow the use of more general indexes. The Consumer Price Index is an illustration—I mention it only as a relatively simple one to deal with, although I understand there may well be statistical and economic problems which may argue that it is not really representative. But why could not inventories be tied in to the Consumer Price Index, the Wholesale Price Index, the GNP deflator, some generally accepted index that has economic validity in the eyes of Treasury and the Congress.

We are sorry for this apparent Government attitude of business be damned, and we would like to urge, if Treasury or IRS is not willing to change their attitude, that Congress should do the job for them.

Another illustration is the concept of debt versus equity. This is truly a small business issue, much more so than a large business, going to the problem of so-called thin capitalization. Assume you incorporate a new business, and capitalize it primarily by putting in your investment as a loan, rather than stock. Payment of interest on the loan is tax deductible. Repayment of the loan to the owner is a nontaxable event.

On the other hand, if capitalization of the new corporation is with stock, payment of dividends is not deductible to the corporation, although included in the income of the recipient; and payment on account of the stock is a taxable transaction involving either redemption or disguised dividends.

Consequently, it is not at all uncommon for new businesses to try to capitalize with fairly high amounts of debt compared to equity. And, correctly, IRS challenges this on occasion if the debt to equity ratio is too high.

In the 1969 Tax Reform Act, Congress provided that Treasury had authority to issue regulations to try to cut through a tremendous amount of sometimes conflicting court decisions on this subject, delineating what may be debt versus equity. Eleven years later, last week in fact, proposed regulations on this subject were finally issued. They provide a safe-harbor rule which, if met, will guarantee that debt will indeed be treated as debt.

What is the safe-harbor rule for debt versus equity? One to one. As long as your debt is no greater than your equity than you are assured that it will be debt.

Now, in 1957, an advisory group of tax experts, academicians and so forth, was set up to report to the Treasury Department and Congress on various aspects of subchapter C of the Internal Revenue Code, and one of the points that they looked at was debt versus equity.

They recommended a safe-harbor rule of a 5 to 1 debt-equity ratio. The courts have almost never disallowed the debt-equity capitalization at less than 3-to-1 ratio. In fact, it is generally accepted today as a rule of thumb that 3 to 1 should be all right, and courts have approved substantially greater debt-equity ratios of 15 to 1 or even more.

A 1 to 1 safe-harbor rule is not a safe harbor. It is nothing. It may be a rule, but it has no meaning. And it has taken us 11 years to get there.

These are only proposed regulations; and I trust that small business representatives will be heard from loud and clear to the Treasury Department, commenting on these proposal and pointing out, if you will, the virtual uselessness of this type of safe-harbor approach.

I assure you we are going to.

Senator BYRD. Give us an example of how that works.

Mr. PADWE. All right.

Suppose we capitalize a corporation with $10,000, or you want to put $10,000 into your new corporation.

The temporary and proposed regulations would say that as long as $5,000 is equity and $5,000 is debt, then the IRS will not try to reclassify any of that debt as equity.

If on the other hand, $4,999 is equity and $5,001 is debt, you do not meet that safe-harbor rule. That does not mean that the debt part will be disallowed as disguised equity. What it does mean is that you do not meet the safe harbor rule of the regulations, and therefore have no assurance that you are safe.

Companies carrying substantial amounts of inventory or investing in substantial amounts of capital equipment are not, where they are new businesses, going to be able to go to the capital markets to provide the financing, the equity they need. They will often have to rely on investment from their owners, and these regulations then become most important to them.

Senator BYRD. This applies only to new businesses?

Mr. PADWE. It can apply to any business, Senator, but essentially it really is a new business issue and a small business issue.

Senator BYRD. Let me see if I can cite an example.

Suppose a company is capitalized at $100,000 and it needs to borrow $300,000 for new equipment. Now what happens?

Mr. PADWE. It depends where the borrowing comes from. If it comes from an outside source, we are not concerned about these regulations. We really are concerned, however, about the borrowing coming from the investors in the company, from the owners of the company, which is why it is normally a new business and small business type of issue.

What the IRS is concerned with is the abuse situation where, for example, I set up a corporation with $1 of stock and $10,000 of debt, and then try to deduct the interest my company pays me. In that case, the debt is really more like stock, and I am getting a tax deduction for an otherwise non-deductible dividend. That abuse does not arise if I borrow the $10,000 from a bank.

So the outside financing sources are really not the problem. It is the new businesses which have to obtain their funds from the original investors that have this problem more than others. And that is why I say it is really a small business issue.

Before my time runs out, Senator Byrd, let me mention a couple of our legislative recommendations, starting with depreciation reform—an area we consider to be extremely important.

We would like to urge your consideration of a limited amount of immediate tax write-off for capital addition, and that thought is not tied in with the British experience. To give this approval a small business orientation, we recommend that the first $100,000 a year only, of capital additions should be permitted to be written off immediately as an expense.

Because of the limited amount of deduction, we believe that tax shelter abuse potential and revenue loss potential is also going to be limited. We would, in order to avoid abuse, suggest that assets qualifying for this election not be permitted the investment credit as well.

We have done some tentative studies on this subject, and we would be happy to supplement this statement with them when we finish our work, but we were not able to complete for this meeting, Senator Byrd. Our preliminary numbers show that, for many types of assets, the immediate write-off without investment credit, may actually produce a lower revenue loss than the Capital Costs Recovery Act which was referred to earlier, with the investment credit; and we feel those numbers would work out for a substantial number of assets depending upon the CCRA class lives, et cetera.

If I may take 1 more minute to quickly make one other last point, we share the concern that you have heard expressed about the Government's regulatory burden on small business, and we go into this in some detail in our written statement.

We have a different approach, however, to solving the problem which we would like you to consider. But we believe that with the staggering costs imposed by Government on business (that again falls disproportionately on small businesses threading their own way through these complex mazes of regulations), it is not inappropriate, rather than talking about sunset legislation rather than talking (as Senator Wallop does in the bill he has proposed) about who bears the burden of proof to show the reasonableness of the regulation, to require Government to pay for some of the costs of those regulations. We are recommending, therefore, that you enact what I would call a regulations tax credit: a credit up to $25,000 a year per business entry or group, for the costs directly imposed on business by Government for complying with or challenging Federal regulations.

Senator BYRD. How do you determine that cost?

Mr. PADWE. It would have to be direct costs only. It could not be allocable costs, such as part of a top executive's salary.

But if a business has to hire three people to fill out forms putting down the same type of information in different formats for 20 different Government agencies, that is a direct cost eligible for credit.

If regulations mandate that certain facilities be constucted to comply, that is a direct cost, although it is a capital cost. We would suggest that the recovery, for credit purposes, be through an amortization schedule.

We feel, frankly, that there are some real advantages to this. First, it is going to become almost instantly cost-effective from a governmental point of view if Government knows that their departments are the ones that are going to have to bear some of the cost, we think that, with a limited cap on the amount of a credit per business, again, the revenue loss—although here I grant you it would be substantial, that it still would maintain a small business orientation.

We would also recommend that the tax system be excluded from the regulations credit, because we have all learned over the last 60 years to live with the tax system and tax regulation and it really is, if you will, a breed apart.

We would request this committee, please, not to allow all future congressional laws to be enacted as amendments to the Internal Revenue Code, in order to avoid the regulations credit.

Finally, to really make it effective, the credit should not be considered a part of the tax expenditure part of the Federal budget but rather, to the extent identifiable, it should be charged back to the budget of the Department or agency whose regulations generate that credit, again for cost-effectiveness.

Senator Byrd, we have other recommendations in our statement and we urge your attention to them, and thank you very much for the opportunity to appear here.

Senator BYRD. Thank you.

I am delighted to have you. I think you raise an interesting point, as to the cost of complying with Government paperwork requirements and so forth.

Mr. PADWE. Senator, you know, with all of the attempts by Government, by Congress, by the agencies to hold down regulations, including the directive of the President to simplify and hold down regulations, in 1978 the Federal Register contained some 61,000 pages. In 1979, the Federal Register contained, I think, something like 77,000 pages.

For 1980, at least through the end of last week, they are going at a rate which, annualized through the end of this year, will produce 84,000 pages of regulations, new and proposed.

In spite of everything, they are growing and growing and growing.

Senator BYRD. Maybe you two certified public accountants would be able to throw additional light on this, but at a meeting of the Virginia Home Builders Association, a tremendous group of them 2 days ago, their spokesman said that 20 percent of the cost of a home is attributable to Government paperwork and Government regulations.

Does that sound somewhere near right to you folks?

Mr. PADWE. It would not surprise me.

Mr. FORSTER. I could not verify the figure, but it would not surprise me either.

Senator BYRD. It seems to me that is a pretty high figure, but undoubtedly it contributes heavily to the cost of a home, just as it does to the cost of many other products, or most other products, I suppose.

Mr. FORSTER. One of the problems with this whole regulatory area is the one I stressed earlier. There does not really seem to be any coordination between the various agencies, so a homebuilder, you could probably get more than one agency. I am sure you would get more than one agency involved in regulating that particular industry.

And there just is not any coordination.

I was at ways and means hearings just the other day on the omnibus maritime bill. The chairman of the Commerce Committee testified at the ways and means hearings and they have pared down significantly the number of the tax proposals they were putting in the shipping bill and despite that—and the bill had been approved by the Department of Commerce as one that they could live with and despite that, the Treasury came in and testified to the fact they were opposed to the one or two tax provisions that did remain in the bill.

Yet Treasury, at the same time, stated that the tax provisions were not needed because in effect, the shipping industry paid no taxes and if that was the case there was no reason to object, either.

It is a real morass.

Senator BYRD. Mr. Padwe mentioned tax expenditures. I think that is a lot of bunk. I do not pay any attention to that.

Mr. PADWE. Congratulations. Others do.

Senator BYRD. To accept that theory, one has to believe in the theory that everything a person makes, every dollar a person makes, belongs to the Government and he is permitted to keep only what the Government tells him he can keep.

This country has always operated on the theory that whatever a person earns belongs to that individual except that the Government can take from him in the way of taxes whatever is essential to operate the Government.

To say because a person contributes to his church, or to a school or library or what have you, that that is an expenditure, to equate that to an expenditure by the Federal Government, it is just to me, bunk.

When a person pays interest on the mortgage on their home, there is a group of people in the Senate, in the Congress and the Treasury Department, who say that that is the same as taking money out of the Federal Treasury. It is just ridiculous to say that when you pay interest on the mortgage on your home and take that as a tax deduction, it is a tax expenditure.

So I do not pay any attention to these things called tax expenditures. What I pay attention to is the amount of money that the Government takes out of the pockets of the taxpayers to spend on public projects. That is what I consider spending.

Thank you, gentlemen.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 461.]

COMMENTS OF ERNST & WHINNEY

SMALL BUSINESS TAX REFORMS AND CAPITAL FORMATION

Presented to the
Committee on Finance
Subcommittee on Taxation and Debt Management

March 28, 1980

Comments of Ernst & Whinney
on
Small Business Tax Reforms and Capital Formation

Ernst & Whinney is an international firm of Certified Public Accountants with more than 300 offices in 70 countries. We provide accounting, auditing, tax and management consulting services to clients engaged in various forms of commercial, governmental and other activities. Our clients include small as well as large businesses.

General Comments

Our comments on this proposed legislation are designed to further the following primary objectives for the small business community:

- Simplification of our tax system;
- Increased equity or fairness in its application; and
- Incentives for greater productivity, capital investment and employment.

We have included comments in this statement on selected subjects that we believe will be of interest to the small business community. The topics that we have focused on are the subjects that were indicated in the hearings announcement and/or were the subject of discussion at the White House Conference on Small Business. None of our comments are made on behalf of specific clients of our firm.

Specific Comments

The following is a list of the subjects on which we have prepared comments for your consideration:

Graduated Corporate Tax Rates

White House Conference Recommendation

Replace the present corporate income tax schedules with more graduated rate scales, extending the graduated corporate tax scale up to $500,000.

Legislative Proposal (S. 2136)

The Small Business Tax Reduction Act of 1979, (S. 2136), would provide corporate tax reductions by adding a sixth step to the current five step structure and extending the progressive range from the first $100,000 of taxable income to the first $150,000 of taxable income. S. 2136 would make the following additional changes:

(1) The bottom bracket rate would be reduced from 17 percent to 15 percent;

(2) The third level (30 percent bracket) would be expanded to $100,000. Currently it covers business income from $50,000 to $75,000.

(3) The fourth level (40 percent bracket) would be redefined to cover $75,000 to $100,000.

The following chart provides a comparison of rates under present law and under S. 2136 and also shows the maximum tax savings for a corporation at each level of taxation.

Curren* and Proposed Rates

Corporate Taxable Income	Tax Rate Under Present Law	Tax Rate Under S.2136	Maximum Cumulative Tax Savings
$ -0- to $ 25,000	17%	15%	$ 500
$ 25,000 to $ 50,000	20%	20%	$ 500
$ 50,000 to $ 75,000	30%	30%	$ 500
$ 75,000 to $100,000	40%	30%	$3,000
$100,000 to $150,000	46%	40%	$6,000
Over $150,000	46%	46%	$6,000

Ernst & Whinney Comments

Tax relief can be achieved by reducing rates directly, by increasing surtax exemptions and/or by restructuring rates to provide desired graduation. Increasing the surtax exemptions (i.e., graduating the rate schedules) would provide greater tax reduction for small business corporate taxpayers, relatively speaking, than would an overall rate reduction for all corporate taxpayers. We support rate reductions effected in such a way as to give smaller businesses greater relief. However, we do not support changes in rate schedules that produce higher tax rates at any income level than presently exist. We believe that greater corporate rate reduction for small business is needed today.

Simplified Accelerated Capital Cost Recovery

White House Conference Recommendation

Adopt a simplified accelerated capital cost recovery system to replace the present complex Asset Depreciation Range (ADR) regulations, with provisions such as (a) immediately expensing capital costs less than a specified amount, (b) immediately expensing government mandated capital costs, and (c) the creation of a maximum annual benefit that may be derived from the system.

Legislative Proposal (S. 1435)

The Capital Cost Recovery Act (CCRA) would replace the concept of depreciation based on the useful life of an asset with a computation using standard cost recovery percentages. In addition, while the type of property eligible for the investment credit under the CCRA system would not change, the rules which make useful life a determining factor for eligibility and which relate to recapture would change. CCRA places all assets in three categories and specifies their cost recovery period. The charts below illustrate how the Act will work.

Investment Classifications

Type of Asset	Recovery Period	Investment Credit
CLASS I .... Buildings and structural components (other than residential)	10 years	10%
CLASS II .... Tangible property, e.g., furniture and equipment (other than that included in Class I or III)	5 years	10%
CLASS III .... Automobiles and light duty trucks, up to $100,000 investment each year	3 years	6%

After the system is fully effective, each year's capital recovery allowance would be determined by applying the fixed percentages in the table below to original cost (salvage value is not considered). In addition, while the amount of the investment credit would no longer depend on the useful life of property, to the extent the property is not held for a specified number of years the credit would be subject to recapture.

Capital Cost Recovery Allowances

Investment Credit Recapture Percentages

Ownership Year	Recovery Allowances			Investment Credit Recapture		
	Class of Investment			Class of Investment		
	I	II	III	I	II	III
1	10%	20%	33%	100%	100%	100%
2	18	32	45	80	80	67
3	16	24	22	60	60	33
4	14	16		40	40	
5	12	8		20	20	
6	10					
7	8					
8	6					
9	4					
10	2					
	100%	100%	100%			

Under CCRA, an investment qualifies for the recovery allowance and investment credit at the earlier of (1) the date the taxpayer actually pays for the property, or (2) the date the property is placed in service. Regardless of when an investment is made during a year, the Capital Cost Recovery Table (as reflected above) provides a first-year allowance as though it were made in the middle of the year. However, a taxpayer could choose to deduct less than the full capital recovery allowance in any year and carry over any portion not deducted to future years.

<u>Ernst & Whinney Comments</u>

In recent years, Congress and the public have been alarmed at the relative decline in productivity, which is responsible in part for increased inflation. Several recent proposals have suggested that one of the major factors influencing the slowing growth of productivity has been inadequate private investment in fixed capital. In order to spur private investment, these measures seek to change current depreciation provisions to permit more rapid recovery of capital costs. Accelerated depreciation reform would aid businesses in obtaining a more realistic rate of recovery and would act as an incentive for business to invest more in productive equipment. It would also make us more competitive with other countries that have already recognized the need for abandoning the useful life concept in favor of rapid capital cost recovery.

Simplicity is a necessary ingredient for any capital recovery system that will benefit small business. Simplicity would help the small businessman overcome the burden of understanding present tax regulations. In addition, it would ease the costs of compliance.

The proposed capital cost recovery system in S. 1435 will meet the needs of small business for simplification of our tax law and for increased capital formation. Small firms will save on recordkeeping and compliance costs under the new system, and will have the flexibility to carry any unused capital recovery allowance forward to be deducted in future years--an important option to firms in loss positions or with widely fluctuating income from year to year.

Treasury figures for 1974 show that while the majority of larger corporate taxpayers elected to use the Asset Depreciation Range System (ADR), only one percent of corporations with assets of $1,000,000 or less did so. This places smaller businesses at a disadvantage with competitors who use ADR or other accelerated methods. The Capital Cost Recovery Act would correct this situation.

Modifications of the ADR rules have been suggested as an alternative to CCRA. The suggested modifications would liberalize the ADR rules by expanding the ADR ranges to 40% from their present 20% range, and by reducing the number of asset classifications. Presently there are over 100 asset classifications. However, when all is said and done small business would still have numerous depreciation methods and useful lives to deal with--a complicated system even in its proposed simplified form.

It has been suggested that a limit or "cap" be placed on the amount of depreciation that could be claimed under the Capital Cost Recovery Act. The purpose of this cap would be to restrict the amount of depreciation that could be claimed by larger businesses in capital intensive industries. We are opposed to the idea of a cap because it would add complication to a simple concept. We think that simplification is the overriding consideration for small business in this matter, and therefore we would not place a cap on CCRA. However, we are aware that some modifications of CCRA may be necessary from a budgetary standpoint.

In addition, as a matter of equity we think a capital cost recovery proposal without a cap will provide more equity. Small business will benefit along with large business, but these benefits will be proportional to their capital investment.

The Capital Cost Recovery Act responds to the needs of the entire business community for depreciation reform, and if adopted, will encourage economic growth and modernization of plants and equipment.

Government Mandated Capital Costs

White House Conference Recommendation

Permit immediate expensing of government mandated capital costs.

Ernst & Whinney Comments

Environmental programs initiated by the Federal Government have placed a heavy burden on business. By way of illustration, it is estimated that total costs for pollution abatement above amount to 2 percent of the GNP ~~and will remain at that level through 1986.~~ Various studies have tied increased private and public sector spending for pollution abatement to the decline in productivity growth and an increase in the rate of inflation. A study by Data Resources, Inc. indicates that from 1978 to 1986 the Consumer Price Index will increase at an average rate of .3 percent and the wholesale price index at .4 percent over an underlying rate of inflation, due to the costs of pollution control required by Federal law.

The increased investment mandated by the Federal Government in pollution control equipment reduces the amount of money available for other private investment. Capital expenditure costs for pollution abatement are especially onerous for small business. Department of Commerce data indicate that in 1977 almost 39 percent of pollution abatement capital expenditures were incurred by firms which employ less than 500 employees. Almost 60 percent of these expenditures were incurred by firms with less than 1,000 employees. It is clear that capital required to comply with government regulations places a heavy burden on a small firm's cash flow.

Immediate expensing or shortening the tax recovery period for pollution abatement equipment would allow firms to more rapidly recoup their capital costs and would release funds for additional investment in productive capital.

Paperwork Burden

White House Conference Recommendation

The Office of Management and Budget should be designated the lead agency for both Federal regulations and paperwork of all agencies and programs (specifically including IRS), with responsibility for forms clearance, paperwork reduction, simplification and elimination; coordinating regulations and cost control oversight; requiring agencies to submit to OMB an economic analysis measuring administrative and compliance costs, particularly for small businesses, of all proposed regulations and paperwork.

Legislative Proposal (S. 93)

S. 93. This legislation would require an evaluation of the paperwork imposed on the public by a proposed regulation and would require each agency to report to Congress every three years on the paperwork requirements of the agency.

Ernst & Whinney Comments

We believe that all businesses--large and small--would welcome a reduction in the paperwork burdens imposed upon them by our government. S. 93 could provide a continuous review and evaluation of all Federal activities which impose costly paperwork compliance burdens. Any initiative to simplify reporting forms, consolidate agency requests, coordinate agency activity and in general reduce the cost of doing business should be strongly encouraged.

Reinvestment Incentives

White House Conference Recommendation

Permit deferral of taxes for rollovers of investments affecting small businesses.

Legislative Proposal (S. 653)

Under S. 653, anyone owning an interest in a small company with a net worth of $25 million or less would be permitted to sell that interest for cash, reinvest that money in another small business and defer any capital gains tax on the sale until the proceeds are taken out of the small business and not reinvested within an 18-month period.

Ernst & Whinney Comments

Adoption of S. 653 would provide a substantial incentive to reinvest small business capital. Under current law, many investors with unrealized appreciation in a small business will either retain the investment or seek to realize that gain by disposing of the investment in a transaction which is not taxable. Tax free mergers and other acquisitions often result in a reallocation of capital away from small business to larger companies. Deferral of the gain until the proceeds of sale are no longer committed to small business investment is likely to provide a significant incentive to investors to reinvest in small business without the artificial bias toward combinations with larger companies.

Subchapter S Corporation Changes

Legislative Proposal (S. 2168)

The Subchapter S Capital Formation Act of 1979 would increase the permissible number of shareholders from 15 to 100 and allow issuance of more than one class of stock.

Ernst & Whinney Comments

Under existing tax law, a small business corporation electing to be taxed under Subchapter S of the Internal Revenue Code must have 15 or fewer shareholders. The shareholder limitations hinder business growth and planning by requiring the investment burden and risk to be spread among a small number of shareholders. Furthermore, Subchapter S treatment is not available to corporations which have any shareholder who is not an individual and which have more than one class of stock. These restrictions preclude certain investors from participation and inhibit investment by persons who may desire special rights as shareholders in return for risking their capital.

We support the proposals contained in S. 2168 because they would lessen the burden on individual shareholders of Subchapter S corporations and thereby encourage investment. However, we believe it would be better not to look at Subchapter S problems in a vacuum. We believe that any revision to the Subchapter S provisions would better be done in the context of an overall revision which would eliminate many of the administrative problems and traps for the unwary taxpayer. Careful consideration should be given to the study prepared by the American Institute of Certified Public Accountants (AICPA) on this subject (Proposals for Complete Revision of Subchapter S Corporation Provisions, AICPA, February 1978).

Reduced Maximum Personal Income Tax Rate

White House Conference Recommendation

Reduce the maximum personal income tax rate from 70% to 50%.

Legislative Proposal (S. 33)

S. 33 would provide permanent individual income tax reductions by lowering individual income tax rates over a three year period beginning in 1980. Under the bill, the maximum personal income tax would be reduced from its present level of 70% to 50% by 1982. In addition, the bill contains an indexing feature which provides for certain adjustments to individual tax rates and personal exemptions.

Ernst & Whinney Comments

Reducing the maximum rate on an individual's investment income from 70% to 50% is desirable from the standpoint of economics and equity. A 50% maximum rate on all income would remove the existing bias against investment income compared to earned income (which already is subject to a 50% maximum rate). This would also raise the after-tax rate of return on savings which is currently taxed at higher rates and would encourage taxpayers to increase their savings--with concomitant benefits in the area of capital formation and employment.

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Touche Ross & Co.

UNITED STATES SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARINGS ON AID TO SMALL BUSINESS

STATEMENT BY GERALD W. PADWE

ASSOCIATE NATIONAL DIRECTOR - TAX SERVICES

TOUCHE ROSS & CO.

MARCH 28, 1980

Mr. Chairman, and members of this distinguished committee:

My name is Gerald W. Padwe, and I am Associate National Director - Tax Services for the international public accounting firm of Touche Ross & Co. I am honored by your invitation to be here this morning and to present the views of my firm with respect to congressional implementation of the White House Conference on Small Business. Unless specifically specified otherwise, the views reflected in this statement are not only my own, but those of Touche Ross & Co. I am accompanied this morning by Mr. Charles V. Fingal, tax manager in our Washington Service Center, for whose assistance in preparing this statement I am most grateful.

Before proceeding to discuss what we believe necessary for the survival and growth of small business in our economy, let me make one point in the area of what I would call "closed business." As you know, taxpayers and citizens are not reticent in informing senators as to what Congress should do, and how the government should be run. Further, most of us are rather quick to let you known when we feel you have done something wrong. By way of balance, therefore, let me state for the record our thanks to this subcommittee and its chairman, as well as to your parent Committee on Finance, for your leadership efforts in the repeal of the carry-over basis provisions -- provisions of a law which would have become an unbelievable nightmare for small businessmen in a relatively short period of time.

Even with the 1979 proposals to "save" carryover, and the raising to $175,000 of the minimum estate to which those rules would have been applicable, the need for the small businessman to understand and comply with this new law would have become acute rather quickly, due to inflation. For example, if our annual rate of inflation were held to 8% over the next ten years, an estate created in 1989 would have been subject to the carryover basis rules had it consisted of $80,000 in assets, based on 1979 dollars (at a ten percent inflation rate, the threshold would have been reduced to $65,000). In other words, estates both large and small would rapidly have become subject to the new rules, and we applaud their removal from the Internal Revenue Code.

What we expect to be the forthcoming repeal of carryover basis, however, still leaves an agenda of potentially frightening size for Congress to contemplate, insofar as the small business entity (individual or corporate) is concerned. However, much of this agenda could be dealt with outside the legislative forum, were government of a mind to do so. Thus, rather than merely stating a laundry list of legislative recommendations, I would like to divide this presentation into two parts: first, what we perceive as a governmental attitude -- removed from the legislative process -- that badly needs changing; but which change could result in substantial relief for the ability of small business to do what it should be doing -- namely, operating enterprises in a free market economy, with the goal and opportunity of earning profits. (To the extent that non-Congressional government attitudes do not change, we would urge Congress to provide the legislative framework which would mandate such a change.) Second, there are some areas not susceptible to relief other than by legislation, and we have a few thoughts for your consideration here as well.

Governmental Attitudes - the Business Perception

There are numerous illustrations of problems caused by apparent taxpayer-be-damned attitudes on the part of the Treasury Department and Internal Revenue Service. In describing four or five examples, we are not inputing motives to any agency. What we are trying to show, however, is how inherent approaches to tax administration may result in roadblocks to business development that need not be there.

The result of these roadblocks is a perception of anti-business bias by our tax administrators -- and a bias particularly against smaller business because of a smaller capacity to deal with the complexities involved. More and more, we read of a growing attitude of antipathy or antagonism between business and IRS, and we suggest that the attitudinal problems exemplified below should bear a substantial part of the blame.

LIFO Inventory Problems

The benefits of LIFO in an inflationary economy need not be gone into here. They are generally recognized, and the large number of companies which have adopted the LIFO method in the past five to seven years (even with the prior stringent financial conformity rules) testifies to business recognition of the advantages derived from utilizing tax deferred dollars to finance the acquisition of replacement inventories which, because of inflation, continue to increase in cost. Further, LIFO is clearly seen as an important way to avoid taxation on illusory profits, based solely on inflation.

Unfortunately, the tax regulations and rulings governing the utilization of LIFO are themselves extremely complex, requiring unusually voluminous and complicated recordkeeping. As a result, many smaller companies make the decision not to adopt LIFO -- not because there is no benefit for them in it, but rather that the initial costs of conversion, plus the maintenance costs on an annual basis (the recordkeeping required, the double pricing of all or statistically sampled items of inventory, the need to maintain annual "layers" of inventories stated in dollar pools) are so burdensome that some companies either find the requirements beyond their capabilities to handle or they find themselves bending the rules to some extent in order to qualify for LIFO on a "practical" approach, thus leaving themselves open to eventual IRS challenge and disallowance of their inventory method.

Within only the past two weeks I recall reviewing correspondence involving one of our midwestern offices, where a client had decided that since his inventory was "only $300,000 or $400,000" it just did not make sense for him to adopt LIFO with all the added recordkeeping burden and the need for outside tax advisors to annually review the highly complex sampling, pricing, and layering calculations. Yet, this was a small businessman facing the same inflationary pressures as industry giants, but feeling the complexity of the law was such that he could not take advantage of a benefit to which he was legally entitled.

The approach of the Internal Revenue Service toward encouraging, or even permitting, the use of LIFO has not been exactly enthusiastic. And, the subject is complicated enough that it is not difficult to throw up roadblocks. While this complexity may be self-evident with respect to manufacturing companies -- with a need to account properly for raw materials, labor, and overhead -- retail establishments also find themselves facing seemingly insuperable difficulties in utilizing the LIFO method. In the case of retailers, the more the items of inventory, the more difficult is LIFO to use -- and we would call your attention here to retail industries such as grocery stores or druggists as illustrative of small businesses maintaining extraordinarily large numbers of inventory items on hand at a given time.

The application of LIFO to taxpayers with substantial numbers of inventory items is particularly onerous. Without going into the details, the taxpayer must know both the beginning and end of year costs and/or selling prices for a representative number of items in inventory. Even though sampling is allowed, judgmental sampling is generally thought to require the extension of the cost/

price data for approximately 70% of the items, whereas statistical sampling utilizes greatly reduced number of items but the methodology of developing the statistical sample requires the relatively expensive talents of statistical experts. While the tax benefits from the use of LIFO by a large retailer will more than offset the sampling costs, small retailers are particularly hard hit by this requirement, since he or she will find that the cost and effort required to perform a judgmental sampling are economically prohibitive, and the cost of hiring a statistical expert to develop the statistical sampling plan (even though greatly reducing the work load) is still prohibitive in relation to the tax benefit from the smaller inventories.

There are many published indexes which attempt to measure the inflation in various aspects of our economy, but the Internal Revenue Service has specifically held, in Revenue Ruling 75-181, that none of these indexes (with one exception) may be used by taxpayers in the absence of convincing proof as to the suitability of such index to a taxpayer's specific inventory.

The one exception referred to is the index published by the Bureau of Labor Statistics since the late 1940s, which is specifically applicable to department stores and certain selected specialty stores carrying reasonably broad line of merchandise similar to that in department stores. Because of this index, which is issued twice a year, many department stores and similar taxpayers (both large and small) can easily avail themselves of the use of LIFO without the necessity to make any of the detailed calculations to properly measure the inflation inherent in their inventories. The incremental cost of this index, by the way, is paid for by the department store industry, and not the government.

Several trade associations representing retail food merchandisers have been negotiating with the Internal Revenue Service and the Bureau of Labor Statistics in an attempt to secure a similar acceptable LIFO index for retail food merchandisers. These negotiations commenced in mid-1975 and are still going five years later, with no hope that an index can be secured before a minimum of at least another year. We are also aware that retail drug stores have entered into negotiations in an attempt to secure a similar index for their inventories. Based upon the slow process of the retail food negotiations, it seems obvious that the retail drug stores face a minimum wait of several years.

This is an area that could be changed by regulation and ruling, rather than legislation. History, however, does not encourage the view that such a change is likely (though, to give appropriate credit, Treasury and IRS have reversed themselves after 40 years with respect to LIFO conformity requirements). Based on the likelihood that change will not be forthcoming through the Executive Branch, we would like Congress to legislatively overturn Revenue Ruling 75-181 and provide that -- in the absence of a particular industry index -- taxpayers would be permitted to use one of the more common published indices; tying inventory to the Consumer Price Index, the GNP Deflator, or some similar index acceptable to Congress as having economic validity.

For manufacturers (though this proposal would also benefit retailers) the switch to LIFO would be made easier if it were not necessary to restore to income in the year prior to electing LIFO all writedowns from original cost (including market writedowns, excess inventory, etc.). In almost all changes of accounting method initiated by a taxpayer, IRS practice has been to permit a ten-year spread of the beginning adjustment arising from the change. LIFO, with its requirement of restoring all writedowns to income in one year is a major exception. We would recommend permitting a ten-year period for the inclusion of the opening adjustment in adopting LIFO; but this would require a change in the statute, rather than merely in the regulations.

Another example in the LIFO area of the conflict between taxpayer and government has been the Internal Revenue Service's strict interpretation of the LIFO financial statement conformity requirement. The LIFO conformity rule has recently been relaxed by proposed regulations issued on July 20, 1979, but the Service's attitude of enforcement prior to these proposed regulations serves as a good illustration of the problems of small business with the government's enforcement of a requirement with questionable value.

The LIFO conformity requirement dates back to the 1939 Revenue Act (which first permitted general adoption of LIFO by all affected taxpayers) and, with the exception of an amendment in the Revenue Act of 1942 to exclude interim reports from conformity, has remained virtually unchanged under existing law. Sec. 472(c) of the Internal Revenue Code of 1954 states that the taxpayer must "establish to the satisfaction of the Secretary" that no other inventory methods other than LIFO were used in annual financial reports to (1) "shareholders, partners, or other proprietors, or the beneficiaries, or (2) for credit purposes."

It is not clear whether the LIFO conformity requirement was passed by Congress to provide support that LIFO clearly reflected the income of the individual taxpayer, or whether the true purpose was to deter taxpayers from adopting the LIFO method so there would not be a significant revenue loss.[1] For whatever reason, the IRS has seen fit to narrowly construe and strictly enforce the LIFO conformity requirement. During the past eight years alone, IRS has issued over 25 revenue rulings and revenue procedures, and numerous letter rulings, on the topic of LIFO conformity. IRS field agents have been instructed to strictly enforce the conformity requirement, and that a violation of conformity may result in termination of the LIFO election (Rev. Proc. 79-23). With regard to the likelihood of termination, the IRS LIFO training manual states: "It is <u>inevitable</u> that an agent will become involved in an examination of a LIFO taxpayer's return that will require the agent to terminate the use of the LIFO method."[2] (Emphasis supplied)

[1] Schneider, <u>Federal Income Taxation of Inventories</u> (1979), 11-32.

[2] IRS Training Manual 3127-01 <u>LIFO Method of Inventory Valuation</u>, 168.

In recent years the LIFO conformity requirement has caused many conflicts between federal regulatory agencies and the IRS. These conflicts were the result of federal agencies <u>requiring</u> reports containing non-LIFO inventory disclosure and information, and each situation was dealt on a case by case basis by the IRS (i.e., Securities and Exchange Commission, Rev. Procs. 76-6, 77-7, and 77-33; Federal Trade Commission, Rev. Proc. 75-30; Commerce Department, Rev. Procs. 75-36 and 76-36; and Council on Wage and Price Stability, Rev. Rul. 79-139).

Finally after nearly 40 years of creating needless hostility between the IRS and LIFO taxpayers, Treasury announced proposed regulations on July 20, 1979 which, in effect, limited LIFO conformity only to the taxpayer's "primary" financial statements, and permitted non-LIFO disclosure as supplementary information in the same financial report. We applaud this giant step forward to eliminate a needless regulatory burden for which there was no sound tax policy reason supporting its existence; but we are left with a recurring question -- why did it take 40 years? LIFO conformity serves as a good example of a statutory provision taken to the extreme by tax administrators, to the detriment of both taxpayers and government. It is hoped that when small business requires relief from the oppressive attitude of government administrators the response will not always be: wait 40 years.

A final illustration of the roadblocks to the use of LIFO has to do with the "link chain" method of calculating a LIFO index. Earlier we referred to the method of calculating an index whereby items of inventory are extended at both the price/cost at the end of the current year and at the price/cost as of the beginning of the first LIFO year. For any inventory items which were not carried as of the first LIFO year, taxpayers must reconstruct what the cost/price would have been in that LIFO base year. This is a very time consuming process, and the longer a taxpayer is on LIFO the more frequently such items appear in inventory.

One way to avoid this computional complexity is to use the link chain method, under which a taxpayer has only to extend items each year at the end of year and beginning of year prices. For those taxpayers not omniscient enough to elect the link chain method in the first LIFO year, permission must be secured from the Commissioner of Internal Revenue before changing to such method. Present IRS policy, however, prohibits the taxpayer from changing to the link chain method unless 100% of the items in today's inventory have been added to inventory within the last five years and, correspondingly, 100% of the items in inventory as of five years ago have now been discontinued. Because of changes in style, engineering, etc., many taxpayers are able to demonstrate a "turnover" of a substantial portion of the descriptive items in inventory but very few can demonstrate the required 100% turnover. In fact, only one client of our firm has been able to meet the stringent 100% test since it was adopted several years ago. Although IRS has informally agreed that 100% is too stringent, they have not yet seen fit to relax it.

Section 385 - Debt vs. Equity

As some authors have noted: "perhaps the most important and potentially far ranging corporate provision added by the Tax Reform Act of 1969 is Sec. 385, which delegates virtually unlimited authority to the Commissioner to define corporate stock and debt by regulations for purposes of the Code."[3] The whole area of debt versus equity has led to much uncertainty, and the large body of case law on this issue has not provided any satisfactory guidelines. On March 20, 1980, eleven years after the Congressional mandate, Treasury has issued proposed regulations on the treatment of certain interests in corporations as stock or equity. The basic tax issues involved in classifying an instrument as either stock or indebtedness are principally threefold:

1. interest paid by a corporation on qualified indebtedness is deductible, whereas a distribution on stock is generally treated as a nondeductible dividend;
2. the exchange of stock for property (i.e., a tax-free incorporation under Section 351) results in no gain or loss to the stockholder, whereas the exchange of debt for property is a taxable transaction; and
3. the repayment of a loan is a nontaxable transaction, but a distribution with respect to stock is either a dividend or a redemption.

The debt versus equity issue is particularly relevant to small business, which is much more likely than large business to

[3] Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 4th Edition, ¶4.05.

be thinly capitalized, or to issue hybrid instruments (i.e, convertible debentures or income bonds) in order to raise capital. Consider the plight of a small businessman forming a new corporation, and attempting to decide how much of his investment should be debt and how much should be equity. Unlike a large corporation, there will not be an open market for the small corporation's stock, so that once the capital contribution is characterized as stock it is impossible to partially withdraw his equity without dividend treatment. If the owner makes a loan to the corporation (at the expense of being thinly capitalized) so that the funds can be repaid in the future, he runs the risk the IRS will recast the debt as equity, and that interest payments in all years subject to audit will be recast as dividends.

As far back as the Report of the Advisory Group on Subchapter C, issued in 1957, it was recognized that what was needed more than anything else in this area was a safe harbor rule to determine when a debt instrument is treated as debt for tax purposes. Among a number of guidelines suggested by the Advisory Group for determining the status of debt were the following:

1. an unconditional promise to pay a sum certain in money for adequate consideration;
2. the debt is not subordinated to the claims of trade creditors generally;
3. the interest rate is not excessive or contingent on earnings, and the obligation to pay interest is not deferred beyond the maturity date of the principal;
4. the ratio of shareholder-held debt or guaranteed debt

to equity does not exceed 5 to 1.

The new section 385 proposed regulations have a safe harbor rule for determining a straight debt instrument; however, the criteria given for the safe harbor area are so narrow that the rule is viewed as virtually useless. The provisions of the proposed regulation safe harbor rule are as follows:

1. the instrument has a fixed maturity date with annual interest payments at a rate ranging from the prime rate to the rate specified in section 6621 (basically 90 percent of prime adjusted every two years on October 15);
2. the debt-to-equity ratio of the Corporation does not exceed 1:1; (that is not a misprint: it says 1:1);
3. all principal and interest on the instrument are paid when due.

The most-notable contrast between the 1957 Advisory Group safe harbor rule and that included in the new proposed regulations is the debt-to-equity ratio. The use of a debt-to-equity ratio of 1:1 in the proposed regulations is highly unrealistic in view of the 5:1 recommendation by the Advisory Group (relating only to shareholder debt and guarantees), and in view of the generally accepted premise that a debt-to-equity ratio not exceeding 3 to 1 is likely to withstand attack.[4] (Courts have approved much greater debt to equity ratios without tainting the debt instruments as

[4]Bittker and Eustice, ¶ 4.04

equity, such as Gloucester Ice and Storage Co. v. Commissioner, 298 F 2d 183 (1st Cir., 1962), with a 15 to 1 ratio; and Baker Commodities, Inc., 48 TC 374 (1967), where a 672½ to 1 ratio did not recast the debt as equity where cash flow and the earnings of the business could cover payments.)

However, the IRS-Treasury approach in the proposed regulations is that unless a small business has a debt-to-equity ratio of 1:1 (which is highly unlikely if equipment or inventories are a major part of the business), the safe harbor rule provides no protection for a shareholder making a loan to his corporation.

We can only hope that taxpayer comment on the proposed regulations will result in an expanded definition of the safe harbor rules, and will provide a basis for meanginful guidelines in this area. We agree that debt versus equity involves an extremely complex and thorny area, but to take eleven years for the issuance of meaningless guidelines gives further weight to our concern about government attitudes (due to the lack of regulations in this area, the IRS National Office has refused to rule on questions dealing with debt versus equity, thus depriving taxpayers of any certainty as to transactions involving this issue -- Rev. Proc. 79-14). Taxpayers have a right to debt versus equity regulations which treat the issue evenhandedly (for both taxpayers and the IRS), and that provide certainty in the structuring of transactions and the financing of businesses.

My firm certainly expects to provide comments to IRS on these regulations, and as to the safe harbor rule they will not be favorable. We urge other interested persons to join us.

Deferred Estate Tax Payments for Closely-Held Businesses

An example of the IRS turning a measure intended to provide relief specifically to small business into an administrative nightmare is found in the extension of time for the payment of estate taxes where a closely-held business comprises a large portion of the estate. Sections 6166 and 6166A of the Code generally provide that taxes can be paid in equal installments over ten years. Of course, interest is chargeable for the deferral of payment, as for any extension of time to pay a tax. The administrative complexity derives from the timing of a deduction for this interest.

In Revenue Ruling 78-125, the Service announced it would follow a court holding that interest on a deferred estate tax payment is deductible on the estate tax return rather than on the estate's income tax return. The Service has yet to announce formally the mechanics of this deduction, but several taxpayers have been informed in private letter rulings (i.e., LTR 8002008) that the amount of interest which will be payable on future installments may not be anticipated. Thus, each year the tax is deferred, the taxable estate will decrease as more interest on upaid taxes becomes deductible from the gross estate.

Based on the private rulings, audit experience, and informal discussions with Service personnel, we gather the Service intends to require the executor or administrator to file an amended estate tax return, Form 706, to claim the increased interest expense which accrues yearly. The Service would then recompute the deferred estate tax based on the new, lower taxable estate. Because the deferred tax is decreased, the equal installments required by the statute would be smaller, and earlier installments, therefore, would have been too large. The excess would be credited against the next tax installment. This refiling and recomputation would be repeated each year of the deferral.

This continuing recomputation, cumbersome enough as it is, causes even more serious difficulties with other provisions of the Code. For instance, an estate is allowed a deduction for certain property passing to the decedent's spouse. In order to maximize the deduction, many wills express bequests to a spouse in terms of a formula based on the "adjusted gross estate". Is an executor required to wait to the end of the ten-year deferral period to finally determine the formula deduction and to make a distribution either to the spouse or a trust established on behalf of the spouse? If a distribution is made, can the executor require reimbursement following the later recomputation? Might the deduction be considered indeterminate at the time of death and therefore not allowable until after the deferral period? These questions remain largely unanswered.

Section 303 of the Code is another relief provision affected by the the Service's approach. It provides that corporate stock redeemed from the estate in order to provide funds to pay estate taxes will be subjected to tax at favorable capital gains rates as long as the total distribution does not exceed all death taxes, and the amount of funeral plus administrative expenses allowable as deductions to the estate. As additions to interest on the deferred taxes increase the amount of administrative expense, will the section 303 limits be altered as well?

The amount of the estate for federal estate tax purposes also relates to state death taxes in various ways. For instance, section 2011 of the Code provides the credit against federal estate taxes for state death taxes paid. Not only would the limits on this credit change, but the death taxes payable in many states would be changed because they are based on the federal taxable estate. It is also possible that a state statute of limitations could bar any refund of state inheritance taxes even though they would not be due using the later, recomputed adjusted gross estate values.

Perhaps the most serious problem in the stringent approach to sections 6166 and 6166A taken by the Service, is that amended estate tax returns would be required long after the statute of limitations had run on refund claims. Sections 6166 and 6166A only extend the time for collection and payment of the estate tax. Under sections 6511(c) and 6501(c)(4) of the Code, there can be no extension of the period for filing a claim for credit or refund of an overpayment beyond three years from the time the initial estate tax return is filed. Thus, the Service's requirement of claiming interest by an amended return after the fact is not only complex, but probably beyond the Service's authority.

This situation, by its very nature, will affect small business owners substantially more than others. Unfortunately, the difficulties spelled out here need not exist; there are reasonable approaches which the Service has not chosen to take. For instance, the amount of interest which would eventually be payable could be easily estimated and deducted from the initial estate tax return. If experience were to show that the interest deduction was incorrect, the Service would still have the power to issue a reassessment, since the statute of limitations for assessments under sections 6166 and 6166A will not run until final payment is made at the end of ten years.

Last Minute Decision Making -- the Crisis Mentality

Internal Revenue has an incredible number of areas it is required to monitor and provide guidance. While, sometimes, the guidance is too long coming -- see our discussion of the debt-equity regulations -- in others, the Service takes a position so late with respect to a given tax year that it defies intelligent understanding to comply. And again, small business -- substantially less likely to have its cadres of Washington representatives reporting back -- bears the brunt disproportionately.

An excellent illustration is less than three weeks old, and involves a highly significant revenue ruling and procedure affecting the tax treatment of inventories. The IRS pronouncements require careful consideration by taxpayers and their advisers, because substantial tax dollars are involved for many businesses -- yet, the rulings were promulgated in the Internal Revenue Bulletin of March 10, 1980, and were required to be reflected on tax returns due March 17, 1980; one week later.

For many small businesses, inventories constitute the largest single capital expenditure. When producing a line of merchandise, manufacturers typically produce goods in excess of current demand. The reason for this excess production is simple: the cost of retooling for a small order of goods at a later date greatly outweighs the marginal cost of producing excess items during the initial manufacturing run. Although manufacturers may keep large amounts of excess inventory, the future demand may be quite small and, unlike retailers who find themselves with excess inventory, a reduced sales price will not increase demand. (There is only so much demand for a part to a 1959 widget.) Therefore, assuming storage costs are minimal, the typical manufacturer will hold excess inventory for a long period of time, and will make occasional sales at a price that neither encourages nor discourages demand. For financial statement inventory accounting purposes, the generally accepted accounting principle of valuing inventory at the lower of cost for market requires companies to evaluate future demand and to write down the cost of excess inventory to the amount reasonably expected to be sold in the future.

On January 16, 1979, the Supreme Court of the United States handed down its decision in the case of Thor Power Tool Co. v. Commissioner of Internal Revenue. The Court held the tool manufacturing company could not write down items it considered to be "excess inventory" on the basis of estimated future demand. The effect of the Supreme Court's decision is that writedowns of excess inventory will not be permitted, even if the writedown conforms to "generally accepted accounting principles", unless the taxpayer meets certain tests under the inventory tax regulations. Such tests require the lower inventory evaluation to be supported by objective evidence of actual offerings, sales, or contract cancellations, and that records of actual sales be kept to substantiate the lower market price. If taxpayer cannot support the lower market price, or did not actually scrap its excess inventory, no writedown of the inventory is permitted.

Realizing that the Thor Power decision affected a wide spectrum of manufacturers, Treasury and the IRS began late in the summer of 1979 to develop a revenue procedure and revenue ruling to assure compliance with the Supreme Court's decision. The correction of prior writedowns of excess inventory constitutes a change in method of accounting which, under the provisions of Sec. 446 requires prior approval by the Commissioner of Internal Revenue. To speed compliance with this issue, Treasury developed a revenue procedure to give taxpayers in a Thor "excess inventory" situation, automatic permission to change their method of accounting.

Although the Supreme Court opinion came down in January, 1979, the resulting Rev. Proc. 80-5 and Rev. Rul. 80-60 did not appear until the March 10, 1980 Internal Revenue Bulletin (1980-10). Despite the fact the Rev. Proc. was published just seven days prior to the initial filing date for calendar year corporate returns, the procedure was "mandatory" for 1979 returns. Although not explicitly stating the consequences for failure to comply, the IRS position was made abundantly clear near the end of Rev. Rul. 80-60:

> "Taxpayers have an obligation to file returns prepared in accordance with appropriate laws and regulations; income tax return preparers are subject to a similar obligation in preparing returns. Therefore, if a taxpayer files a Federal income tax return not using the 'prescribed method' of inventory valuation the taxpayer will have filed a return not in accordance with the law."

We feel the above cited language may be overly broad but, more to the point we are dealing with here, such a position announced one week before the due dates of many affected returns can only lead to an increased feeling of disaffection and alienation between taxpayer and government. The IRS position could have been just as well made applicable to 1980 as 1979, allowing a more rational approach to compliance, and costing the government only the use of money for one year. The present approach leads to a perception of arrogance and a crisis mentality not conducive to a properly balanced relationship between business and government.

Tax Compliance

We are proposing, in the second part of our testimony, below, several steps which, if adopted, will make the tax compliance burden on small business significantly less onerous. With respect, however, to the general subject of governmental attitudes, we would like to make a few comments about another aspect of tax compliance; namely, the imposition of penalties for negligence by the Internal Revenue Service on preparers of income tax returns for others.

In an attempt to curb abuses in the preparation of income tax returns for compensation by preparers not properly trained in tax law, the 1976 Tax Reform Act provided a number of safeguards; such as the requirement that a preparer sign the return, give a copy to the taxpayer, maintain records for the IRS on returns prepared, etc. The rules also permit IRS to impose misconduct penalties for failure of the preparer to consider adequately appropriate "rules and regulations" in positions taken on income tax returns.

And, in what we believe to have been a mistake, Congress (represented by the Conference Committee considering the 1978 Revenue Act) permitted the "rules and regulations" term to be extended to published rulings of the Internal Revenue Service, despite the fact that such rulings had never been elevated to such a high level of precendential value heretofore. (The more usual perception of an IRS published ruling may be found in a sentence from the Tax Court opinion in Estate of Grace E. Lang, 64 TC 404, at 406-7: "A revenue ruling, without more, of course, is simply the contention of one of the parties to the litigation, and is entitled to no greater weight.")

While the legislation was aimed at abuse situations, it was drafted broadly enough to cover any individual preparing an income tax return for compensation. This includes attorneys, certified public accountants, and other professionals. Unfortunately, there is growing indication that the Internal Revenue Service is using the negligence penalty provisions as a "happy hunting ground" in which to require professional advisors to take conservative positions for their clients on tax returns -- following published IRS rulings, which may or may not be upheld in court -- or face the imposition of penalties for negligent or intentional disregard of rules. It is our view that larger firms will be less affected (given the number of full-time, sophisticated tax practitioners in national and regional firms); however, it is the smaller practitioner (primarily the CPA firm), which often acts as financial and tax advisor to small business, that we believe more likely to take a more conservative approach to tax planning and tax compliance for their clients than need be, under the implicit threat of penalty; and in such case, it is the small business taxpayer that ultimately pays the price. We believe any "in terrorem" approach to forcing a taxpayer into a more conservative stance raises serious policy considerations.

We are mindful of the fact that the preparer regulations permit good faith disagreement with rules or regulations to avoid the negligence penalty if there is reasonable support for such disagreement. However, a good faith disagreement is a highly subjective standard of use, and the practioner bears the burden of showing IRS that he was aware of the published ruling, disagreed with it in good faith, and therefore declined to follow it.

The Joint Committee on Taxation General Explanation of the Revenue Act of 1978 (page 400), referring to the decision to have the preparer penalty rules apply to IRS published rulings, pointed out:

> "The Congress directed that the Internal Revenue Service shall reasonably interpret sections 6694(a) according to the standards of Section 6653(a) and in light of all the facts and circumstances of each case, taking into account any and all mitigating factors. (Emphasis supplied.)"

We believe it appropriate for the Congress to exercise its oversight power to satisfy itself whether that direction has been carried out. We believe it has not, and we are particularly concerned as to the implications of likely asserted misconduct penalties on the ability of small business to obtain appropriate tax advice and tax reporting. The Service has made no bones about the fact that in the absence of increased budgetary allocations from Congress, it would like to see professional advisors bearing more responsibility for helping IRS perform its audits. In terrorem tactics have no place in fulfulling that goal, and in the interests of the business community they should be stopped.

And, while this is a legislative recommendation and more appropriately belongs below, we would urge the Congress to restore the provision approved by the Senate in its consideration of the 1978 Technical Corrections Bill (ultimately incorporated in the 1978 Revenue Act) that the disregard of a published IRS ruling does <u>not</u> consitute a negligent or intentional disregard of rules or regulations for purposes of the preparer penalty provisions.

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While we have included a few legislative suggestions in the above comments, their major thrust has been to illustrate problems faced by small business and its owners which could be solved, in general, without any addition to the Internal Revenue Code. We believe that no conscious anti-business (small or large) bias exists in the thinking of Treasury or IRS personnel responsible for preparing regulations and rulings. And, we certainly recognize that abuses of the tax system do occur -- and they exist among small businesses as well as large. Further, since our tax system produces the revenues needed to fund government programs, we have sympathetic understanding for the need to "protect the revenue".

However, we feel the pendulum has swung so far toward the side of curbing abuse and protecting revenue as to result in the perception of "not giving a damn" about the practical problems of the business community -- and particularly the small business enterprise which is more likely to try and thread its own way through the maze of complex regulations and rulings.

That attitude needs to be redressed. And, implicity, Congress seems to have recognized the same problem, though perhaps from a somewhat different perspective. I have personally been an observer of the tax scene for over twenty years, but never in that time have I seen such Congressional involvement in tax administration rather than tax policy, as was the case in the 1978 Revenue Act. In fact, in the booklet describing that law prepared by my firm, we devoted several pages to provisions involving what we called: "Curbing Administrative Overenthusiasm".

We think it unfortunate that Congress should have to be involved in holding back administrative agencies dealing with tax matters. However, note the Congressional concerns as exemplified in the following areas:

1. "Freezing" IRS regulations and rulings on fringe benefits.
2. Overriding, legislatively, proposed regulations on deferred compensation.
3. "Freezing" the existing distinction between who is an employee and who is an independent contractor.
4. Legislation overriding IRS change in position on cafeteria plans.

5. Legislation allowing taxpayers requesting IRS rulings on the exempt status of industrial revenue bonds to appeal adverse or no rulings to the U.S. Tax Court.

More recently, not involving the 1978 Revenue Act, it took Congressional pressure to elicit a commitment from the Secretary of the Treasury to become personally involved with the revision of proposed regulations on foreign tax credits -- regulations which, if ultimately promulgated in their proposed form, would drastically revise the foreign tax rules under which we have operated for sixty years, and would make the costs of doing business abroad substantially more expensive.

We urge continuing Congressional attention to the area of tax administration. While deploring the need, we must encourage your involvement. And, we would certainly hope that Treasury and IRS could adopt a more pragmatic approach to administrative rules and regulations. So much could be accomplished, without the need for legislation, by a change in attitude within that part of the government.

We turn now to specific areas requiring legislative implementation in aid of small business.

Legislative Recommendations

Depreciation and Capital Formation

Much has been written and spoken on the subject of depreciation reform in the past several years; in fact, there seem almost as many plans to "reform" our system of tax depreciation as there are persons prepared to comment on it. Two of the bills which provide possible subject matter for this hearing deal with the subject of depreciation: one is the well known Capital Cost Recovery Act (or 10-5-3 bill), and the other would permit a 36-month straight line writeoff of up to $25,000 capital additions in a taxable year.

It is unfortunate, but any depreciation "reform" becomes highly controversial for two reasons: first, any increase in depreciation deductions results in revenue losses to the government and, second, there is immediate, and justifiable, concern on the part of Treasury as to the possibility for tax shelter abuse centered on this technique. Still, we believe Congress should consider the subject of liberalized depreciation as an essential agenda item for small business. And, at the risk of appearing naive, we believe this Congressional attention should be focused not on the problem of how long or how short a class life should be, but why a small business taxpayer should not be able to take an immediate and full writeoff of a certain part of his capital additions. We believe, given appropriate maximum limitations on annual property additions subject to immediate deduction, both the revenue losses and the shelter abuse potential can be kept at manageable levels.

deductibility. $100,000 investment in plant and equipment by a small business, with a full tax deduction, can have a highly significant effect on its investment decisions; the same cap is hardly likely to cause General Motors or IBM to change their capital investment strategies.

To prevent the equivalent of writing off more than 100% of cost in the year of acquisition, we would recommend that any property subject to the immediate deduction election not be eligible for the investment tax credit. And, given the immediate deductibility of the asset cost, sale of the asset - whenever it occurs - should produce section 1245 recapture up to original cost.

We would anticipate that, given the nature of immediate deductibility of capital outlays, initial reaction would focus on the expense of such a proposal. However, preliminary and tentative review of some studies indicates that the revenue loss for immediate writeoff without investment credit may actually be less, in many instances, than under the Capital Cost Recovery Act with investment credit. We would be happy to expand on this point in a subsequent letter, after some further study.

We recognize that this proposal, though clearly simplifying the tax depreciation system for the great majority of small businesses, will cause complexity for those companies whose capital additions in a year exceed $100,000, but who still wish to take advantage of the immediate writeoff election; primarily because of the record keeping problems inherent in two depreciation systems. We believe, however, the complexities are no worse than those in some of our present depreciation rules, such as ADR, and that the capital formation incentive is so significant that many businesses would happily pay the price of the added complexity; still, we would be happy to work with appropriate staff personnel to develop proposals that would minimize the added complications for affected taxpayers.

Pre-Operating Expenses

Present tax rules operate as a disincentive to entrepreneurship in their treatment of necessary expenses incurred before a new business actually commences on a day-to-day basis. Prior to the beginning of operations, individuals contemplating a new business venture are faced with costs of looking into business prospects, markets, capital availability, etc. After the decision to enter a particular business has been made, but prior to the time that the new venture begins operations as a going concern, numerous other expenses are incurred.

With the exception of the limited category of organizational expenses, as well as a few others which are specifically deductible under various provisions of the Internal Revenue Code, these so called start-up or pre-operating expenses are not deductible for tax purposes. In brief, they are not considered ordinary and necessary expenses incurred in "carrying on" a trade or business, because the trade or business has not been established. While, on the other hand, they do establish the cost of an intangible asset relating to the business, the asset is not amortizable since the business does not have an ascertainable life.

Further, for noncorporate taxpayers, these costs will not even be deductible should the investigation fail and the business never get started. While a corporate venturer could claim a loss deduction under present law for the pre-operating costs now abandoned, a noncorporate taxpayer can only obtain such deduction if the transaction was entered into for profit, and investigatory expenses have been held by the courts and the IRS not to meet this criterion.

Almost by definition, this is a small business issue. Large businesses tend to have been operating for some period of time before they grow into that category; their costs of looking into a new but related business will normally be permitted as deductions as an integral part of the business they are presently in. It is, however, the individual or group of individuals wishing to start a new (and, therefore, very likely a small) business who find the tax laws throwing still one more roadblock in their path.

Senator Roth introduced a bill -- S.1638 -- in the first session of this Congress which would permit an election to amortize such pre-operating expenses over a 60-month period (parallel to the treatment presently granted to organizational expenses). That bill deserves enactment, and we urge your support for it. Unfortunately, it is the kind of bill which is not likely to have a vocal constituency, since it relates only to businesses not yet formed. However, present tax treatment discourages entrepreneurs from seeking to enter new businesses and, by requiring that virtually all pre-operating costs be funded with after-tax dollars, undoubtedly increases the rate of failures of new business ventures.

The Regulatory Burden

While not specifically a tax issue, the regulatory burden imposed by over 100 U.S. government agencies (of which the Internal Revenue Service is not even the most familiar to some companies) has deservedly been called "the hidden tax." Some agencies -- OSHA and EPA are examples -- impose requirements on business that may cost substantial amounts of money to comply with (including the construction of facilities); and these costs can have a significant impact on business decisions of the affected enterprises (it is recognized that some of the very smallest businesses may be exempt from certain agency requirements, but in the general concept of the term "small business," most will probably have to be responsive to the requirements of some, if not all, government agencies with appropriate jurisdiction). Others may not require the direct expenditure of funds on facilities, but may impose detailed and burdensome reporting requirements that divert people and hours to answer. Worse, agencies unrelated to each other, save for their common parentage of the U.S. government, often wind up asking for the same or similar information, but on different forms and in different reporting formats, thus not even permitting economies of scale by the complying business.

The direct and indirect cost of compliance with government regulation is staggeringly high. We believe such cost falls disproportionately heavily on smaller businesses (to the extent they are not exempted by virtue of their very small size). One of the most frustrated and anguished cries we hear from small business clients, is "Why can't the government get off my back!" In fact, a November, 1979, survey of small businesses in the New York metropolitan area (conducted for Chemical Bank by Louis Harris and Associates, Inc.), showed a small business perception that government regulations will become a more serious problem in the future than they are today. A sample of almost 700 businesses was shown a list of 15 items, and asked a) which item is the <u>single</u> most serious problem for your business today and, b) which will be in the 1980s. "Government regulations" was fourth for 1979 (after quality and cost of labor, inflation, and finding top quality management), but was seen as third most serious for the '80s (after inflation, and labor quality and cost).

We recognize that both Congress and the Administration are bending efforts to resolving some of the problems imposed by government regulation. Regulatory reform is the subject of numerous bills presently before congressional committees. The President has directed that agencies take steps to simplify regulations and to make them cost effective. Still, with all the effort being expended to hold down regulations, the 1978 Federal Register contains 61,261 pages, the 1979 edition contains 77,497 pages, and the 1980 Federal Register (through March 20) is proceeding along at a rate which, if annualized, will produce 84,000 pages of regulatory and other material for our information and guidance this year.

We think there is a more effective way to deal with the regulatory burden than a sunset approach, or determining whether government or citizen has the persumption of correctness on his side. Our suggestion is simple, can be tailored to a small business orientation, and will be cost effective -- from the government's point of view -- almost automatically. It is, simply stated, to let the government pay for the regulatory burdens it imposes on business. However, to recognize government's legitimate aims in mediating amongst a pluralistic society with many competing interests, and to recognize the disproportionate weight of regulations on the small business enterprise, a maximum should be placed on the amount required to be borne by the government each year with respect to a particular business.

We would recommend a tax credit for the amounts business can show to be directly incurred in compliance with -- or in challenging -- federal government regulations. Such creditable costs would not include an allocable part of corporate overhead, such as general executive compensation; we suggest a "cap" of $25,000 annually on the regulation credit, per business; carry-backs and carryovers could be permitted to the extent that a particular year resulted in extraordinary expenses for a small business to comply with regulations; and the cost of capital additions mandated by regulation could be recovered over a period of years through an amortization schedule. Since the tax system seems to be a breed apart with respect to the federal regulatory process, it should be excluded from operation of the regulation credit -- but with a caveat to this Committee and the Ways and Means Committee not to permit every future bill to go through Congress as an amendment to the Internal Revenue Code, in order to avoid the operation of the regulations credit. Finally, to the extent identifiable with a particular regulation, we would urge that the credit not be considered a tax expenditure for budget pruposes; rather, it should be assigned to that department or agency whose regulations were responsible for its generation.

Frankly, we see nothing wrong with government being required to earn its own way -- even on a small scale. From that perspective, the proposed regulations credit has a great deal of attractiveness.

Retirement Plans

The tax rules affecting corporate versus noncorporate retirement plans are such that small business owners are virtually forced into choosing the corporate form of operation, in order to obtain the maximum tax benefits in establishing a plan for retirement. Unfortunately, that partially tax-dictated choice of business entity has many other ramifications which flow as a natural consequence: the need for income to be double taxed before arriving in the hands of the owner where, in a proprietary form, this would not occur; the problem of reasonable compensation versus dividend; the problem of accumulating earnings before paying a penalty tax under section 531; the debt versus equity issue discussed earlier in our testimony; and others.

The major inequity of tax treatment for contributions to a self-employed retirement plan as opposed to a corporate plan was set out by William L. Raby of my firm, in a letter dated February 12, 1980 to the sponsors of companion bills H.R. 6140 and S. 2128. Copies of that letter were sent to all members of this subcommittee and the Committee on Finance. Accordingly, we do not intend to repeat its detailed points here, though I would like to attach it as an exhibit to this statement for the record of these hearings.

In brief, we pointed out that corporate limitations on retirement plan contributions are indexed to the cost of living, while limitations for self-employeds are not. A defined contribution plan, for example, which permitted a deduction of up to $25,000 for a corporate employee in 1974 (the year ERISA was enacted) permits a deductible contribution up to $36,875 in 1980. For self-employed defined contribution plans, the equivalent deductibility limitations were $7,500 in 1974 and $7,500 in 1980 -- an inequity for which we find no justification, and which gets worse each year. Analogous numbers exist for defined benefit plans.

We recommended then, and repeat now, that skewing of entrepreneurial decisions on business form toward the corporation should not be based so largely on retirement considerations. We recommend that self-employeds be given equivalent deductibility limits as their corporate peers or, at the very least, we recommend a one time catch-up in cost of living adjustments to the self-employed limitations between 1974 and 1980, with future limitations also adjusted for the cost of living. That would not cure the inequity; it would, however, keep it from getting worse each year, as is now the case.

Inflation and the Small Business - Income Taxes

Congress has been keenly aware of the effects of inflation on tax rates and certain other monetary limitations set forth in the Internal Revenue Code. In an effort to help small business, we believe Congress should continue to monitor certain limitations in specific Code sections which directly relate to small business.

One provision which can strongly penalize closely held corporations retaining funds in the corporation beyond the "reasonably anticipated needs of the business" is the accumulated earnings tax under section 531. The accumulated earnings credit under section 535(c) permits small companies to accumulate a minimum amount of earnings and profits without the risk that the accumulation will be deemed unreasonable and for the purpose of avoiding dividend payment. The minimum amount was originally set at $60,000 in the 1954 Code, increased to $100,000 in 1958, and was further increased to $150,000 in 1975. Since the accumulated earnings credit relates to aggregate earnings accumulated during a corporation's entire life, the credit only directly benefits small companies. Given the ravages of inflation during past years, Congress should continue to be mindful of updating this special provision for small business.

Another Code provision relating principally to small business is section 1244, which allows ordinary loss treatment from losses on small business stock. The maximum section 1244 loss is $50,000 ($100,000, married filing joint return), and was recently increased from $25,000 by the Revenue Act of 1978. Section 1244 provides favorable tax treatment for losses on small business stock and eliminates tax disincentives (i.e., capital loss treatment) on investments in speculative small business corporations. Given the importance of this section to small business, Congress should be alert to update the section 1244 loss limitation in the future as inflation continues to erode the effective benefit of the maximum loss.

Inflation and the Small Business - Estate and Gift Taxes

One of the most difficult problems facing small business in America today is that of dealing with the prospect of estate taxes upon the death of the owner or major stockholder. Unlike large corporations, where management can arrange for the orderly succession of the chief executive officer, the small business is more likely than not faced with the traumatic event of providing both management continuity and the cash necessary to fund the owner's estate tax liability. For the small business that has not received proper counseling, and has not planned for the liquidity problems that death brings, the estate tax burden can be truly catastrophic.

We are not advocating the exemption of small business owners from the estate tax, although if it is agreed that the estate tax is not an important source of revenue, one questions the socially desirable objective of breaking up or severely disrupting closely held businesses in smaller estates. What we are advocating, however, is that Congress recognize the interplay of inflation on the progressive estate and gift tax rates, and take steps to eliminate the inflationary increases which move estates into higher tax brackets.

Congress has recognized this problem as to income taxes, and taken steps to deal with it. Since the enactment of the Internal Revenue Code of 1954, individual income tax rates have been adjusted at least five times, with the result that the personal tax burden as a percentage of income has stayed -- on average -- amazingly consistent.[5] This has been accomplished despite inflation by reducing rates, by increasing the standard deduction and by enacting new credits such as the earned income credit, to remove certain taxpayers from the tax rolls.

But what has happened to estate and gift taxes during this period? The Tax Reform Act of 1976 substantially revised the old $60,000 estate tax exemption and the $30,000 gift tax exemption

[5] Former Assistant Treasury Secretary Laurence N. Woodworth, in a speech before the 1977 National Journal Conference on Tax Policy, noted that from 1945 to 1977 individual income tax collections had remained about 10 percent of personal income for each year, fluctuating only between 9.2% and 11.6% over a 30-year period.

to provide for a unified credit, effectively resulting in a combined estate and gift tax exemption of approximately $175,000. This updating of the estate and gift tax exclusion is commendable; however, it took Congress over 34 years to compensate taxpayers for the 257 percent increase in inflation between 1942 and 1976. And, the $90,000 and $175,000 numbers are not comparable since, for instance, it is no longer possible to transfer assets by gift from the highest estate tax bracket to the lowest gift bracket; and the lowest rate of tax on a taxable gift is no longer 2½%, but 18%.

From 1976 to 1979 the Consumer Price Index has increased 32 percent, with inflation in 1979 exceeding 13%. If Congress does not act quickly by 1983, the $47,000 unified credit (even if it were comparable), will actually be worth less than the old $30,000/60,000 gift and estate tax exclusion (assuming a 10 percent inflation rate). Accordingly, we support S.1825, to increase the unified credit to $70,700.

In addition to converting the specific exemptions to a unified credit, the Tax Reform Act of 1976 also created a unified rate schedule for estate and gift taxes. Under pre-1976 law, gift tax rates ranged from 2½ percent on the first $5,000 to 57 3/4 percent on taxable gifts in excess of $10 million. Estate tax rates, which dated back to the 1939 Code, ranged from 3 percent on the first $5,000 of the taxable estate to 77 percent of the taxable estate in excess of $10 million. Instead of widening the estate tax brackets to take into account the effects of inflation since 1939, the 1976 unified estate and gift tax rate table actually resulted in an increased tax for the majority of estates. Although the 1976 unified rate table reduced the top estate tax rate from 77 percent to 70%, taxable estates of less than $7 million are actually taxed at a higher rate than under prior law.

Another provision in current law badly in need of updating, is the $3,000 exclusion which originated in the Revenue Act of 1942, and has not been changed despite the 345 percent increase in the Consumer Price Index from 1942 through 1979. We support the approach of S. 1984, which would double the exclusion to $6,000, but suggest that number is still not high enough.

On Monday, March 24, 1980, your committee heard witnesses testify in favor of estate and gift tax "relief." We are not making the above points to suggest "relief;" rather, we believe Congressional recognition of inflation in the estate and gift tax area constitutes a restoration of simple equity, similar to the same concern with inflation for which Congress has seen the need in income taxes. Given the neglect of the estate and gift area in the past, now is the time to act.

Touche Ross & Co.

February 12, 1980

The Honorable Lloyd M. Bentsen,
Al Ullman, Dan Rostenkowski,
and Barber B. Conable, Jr.
U. S. Congress
Washington, D. C.

Dear Senator Bentsen, Chairman Ullman, and Congressmen Rostenkowski, and Conable:

As a major public accounting partnership, we would like to present our views on the two companion bills recently introduced in the House and Senate, and aired at preventing "abuses" in the use of professional corporations to avoid the limitations imposed on deducting contributions to, and providing benefits from, retirement plans for the self-employed. We are writing you as an original sponsor of one of the bills.

Our purpose in this letter is not to condone abuses; rather, it is to suggest that the bills introduced deal with a symptom rather than the disease, and to request that while you are considering what you perceive to be abuses in this area, you also consider what we see as the real problem leading to those actions: namely, the tax treatment of self-employeds as second or third-class citizens in providing for their own retirements.

Discussion of Problem

On December 13, 1979, identical bills were introduced in both the House and the Senate (H.R. 6140 and S.2128) dealing with the abuse of certain pension plan provisions through the use of separate professional corporations. The bills represent Congressional response to two recent Tax Court decisions (Thomas Kiddie, M. D., Inc., 69 T.C. 1055 (1978), and Lloyd M. Garland, M.D., 73 T.C. No. 2 (1978)). In each of these cases the Tax Court held that employees of a partnership, owned 50 percent by two separate one-man professional corporations, need not be covered by the qualified pension plans set up in the professional corporations for the benefit of the sole shareholder.

The obvious pension plan "abuse" illustrated by Kiddie and Garland is that by incorporating the principal professional individuals in a partnership, one-man pension plans can be set up by each of the professional corporations. Such plans exclude all partnership employees (presumably lower paid) from the pension coverage manadated by ERISA had the plan been established at the partnership level. H.R. 6140 and S.2128 prohibit such an arrangement by modifying the statute governing qualified pension and profit sharing plans so that all employees of an "adjunct professional organization" and all employees of the professional corporation it is related to, will be treated as employed by a single employer, thus resulting in pension coverage of all employees as required under existing law.

Although we understand the attraction of closing loopholes to prevent abuse, we question in this instance whether Congress may be treating the symptom, rather than the cause of the problem. The establishment of one-man professional corporations and one-man pension plans in Kiddie and Garland should be viewed, in our judgment, as a manifestation of a larger underlying tax policy problem; that is, the inequity in tax benefits between the H.R. 10 self-employed retirement plans and the benefits available under corporate pension or profit-sharing plans. The solution further complicates this already complex part of tax law. We think we have a better solution - and one that will contribute to long run simplification in this area.

In recent years we have witnessed a dramatic increase in the number of professional corporations, based primarily on the tax advantages available through pension and profit-sharing plans when practicing in the corporate form. After losing numerous cases in the late 1960's, the IRS now recognizes "organizations of doctors, lawyers, and other professional people organized under the state professional association acts as corporations for tax purposes" (Rev. Rul. 70-101, 1970-1 C.B. 278). All of the states, including the District of Columbia, now allow qualifying professional groups to practice as professional corporations, or associations taxable as corporations.

The inequities in the tax law between H.R. 10 plans and corporate plans encourage the formation of professional corporations. In simplified form, they are summarized on the page attached to this latter. We believe you should consider them before merely deciding to "close the loophole" recognized in the Kiddie and Garland cases.

Not only is there a massive difference in the contribution limitation applicable to self-employeds and those applicable to a corporation, but corporate plan limitations are also indexed for cost-of-living adjustments (Code Section 415(d)). For example, as a result of ERISA in 1974, the maximum contribution to a H.R. 10 plan was increased from $2,500 to $7,500, while the corporate limitation for a defined contribution plan was set at $25,000. But, due to adjustments, while the 1980 H.R. 10 maximum contribution is still $7,500, the maximum corporate contribution has increased 48 percent to $36,875.

The discrepancy between self-employed plans and corporate plans is even more dramatic in the defined benefit area. Under ERISA, self-employeds are permitted to utilize defined benefit plans for the first time; however, statutory guidelines impose substantial restrictions in terms of the limitation on benefits that many self-employeds may enjoy. Congressional intent is exemplified in the Conference Committee report for P.L. 93-406, commenting on Internal Revenue Code section 401(j):

> "The substitute authorizes Treasury regulations to allow self-employed persons and shareholder-employees in effect to translate the 15 percent/ $7,500 limitations on contributions into approximately equivalent limitations on benefits which individuals can receive under a defined benefit plan."

While regulatory changes are permitted after 1977 (none have yet occurred - in fact, proposed regulations under the 1974 law as to this subject were not issued until May, 1978), such amendments may consider only changes in mortality rates and interest rates, not cost of living adjustments.

For corporate defined benefit plans, however, the 1974 Act initially provided for funding a maximum annual benefit of $75,000 - and also provided for cost of living indexing. The annual benefit limitation for a corporate plan has increased from $75,000 in 1974 to $110,625 in 1980. As an example of what this means, the annual contribution to a corporate pension trust to fund retirement at an annual rate of $110,625 for an employee age 50, scheduled to retire at age 60, is $134,000. A comparison of this contribution limitation with that available under H.R. 10 rules eliminates any doubt as to "why" professionals incorporate.

In addition to the differences in deductible contribution limitations, a corporate retirement plan has other advantages over a H. R. 10 plan. Under a qualified corporate plan, executives are allowed to make nondeductible voluntary contributions to the plan; generally up to 10% of compensation, thus allowing a tax-free accumulation of earnings on their contributions until retirement. This benefit can be contrasted to the limitations on voluntary contributions to a self-employed plan. Generally, owner-employees can contribute only up to $2,500 on a voluntary basis, with Code Section 4972 imposing a 6 percent excise tax on contributions in excess of that limitation. Another significant advantage of corporate plans is the estate tax (Sec. 2039(c)) and gift tax (Sec. 2517(b)) exclusion for qualified plan annuities payable to an employee's beneficiary upon his death. This tax benefit is not available to the self-employed.

Conclusions and Recommendations:

It is a fact that tax policy influences economic behavior. Tax incentives or disincentives are created by Congress to influence the economy and to achieve socially desirable objectives. Congress has recognized it is in the national interest to encourage the formation of retirement plans through the use of tax incentives. The assets in these plans are now the single largest tool of investment capital in our country. It is clearly in the public interest to promote this type of saving.

Assuming there are sufficient safeguards in the law requiring the coverage of all employees under both self-employed and corporate qualified retirement plans, where then is the socially desirable objective in discriminating against self-employed individuals and their employees? The overriding tax benefits available from corporate retirement plans (as opposed to H. R. 10 plans) encourage professionals to incorporate and result in a biased tax system which penalizes those self-employed individuals choosing not to incorporate. Any public policy considerations involved would indicate that professional incorporation, if anything, should be discouraged, as it was by all states until federal tax discrimination became so overwhelming that state laws were changed.

Finally, we are not persuaded that revenue considerations should be a factor in deciding whether to grant self-employeds comparable contribution deductibility and benefits to their corporate peers. Clearly, giving such comparability will result in short term revenue losses to the federal government. However, continuing with the present rules is an indirect way of saying: "you may be receiving inequitable treatment, but it would cost too much to grant you equity." You, as well as we, are constantly reminded by Treasury about the need for horizontal and vertical equity when it comes to tax reform - or, indeed, to tax relief. This inequity has been in existence for too long to be ignored; particularly where, because of the indexing provided for corporate plans, it is getting worse.

We would, therefore, strongly urge your favorable consideration of provisions that would put self-employeds on a truly comparable basis to those who are now covered under corporate retirement plans. This would require a substantial number of changes to simplify the present Internal Revenue Code. We would be happy to work with any of the Congressional staff to draft appropriate language.

As a bare minimum, Congress should provide self-employeds with both parallel indexing to the corporate plan rules and a one time "catch up" index provision for H. R. 10 plans, to move from 1974 limitations to those that should be in effect for 1980 on a comparable corporate basis. This would not cure the inequity problem; it would, however, maintain the inequity at the same level rather than making it increasingly worse from year to year as is now the case.

We appreciate your consideration of our thoughts, and would be happy to expand on any of them, if that would be helpful to you.

William L. Raby (LA)

William L. Raby
National Director - Tax Services

CC: Chairman Russell B. Long
Members, Senate Finance Committee
Members, House Committee on Ways and Means
Bernard M. Shapiro, Joint Committee on Taxation

CORPORATE VS. SELF-EMPLOYED
RETIREMENT PLANS

	Corporate	Self-Employed
Contribution limitations		
1. Indexed to cost of living?	Yes	No
2. Defined contribution plans		
a. 1974	$ 25,000	$ 7,500
b. 1980	36,875	7,500
3. Defined benefit plans - "approximately equivalent" limitations based on		
a. 1974	75,000	7,500
b. 1980	110,625	7,500
Additional contributions by covered personnel		
1. Earnings tax-free?	Yes; voluntary contribution up to 10% of compensation	6% tax on contributions over $2,500 for 10% owners
Estate Tax exclusion for annuity to beneficiary on employee's death?	Yes	No
Gift tax exclusion for such annuities?	Yes	No

Senator BYRD. Next is a panel of four small businessmen: Dr. Gilbert Levin, president, Biospherics, Inc., Rockville, Md.; Mr. Wilbur Doyle, president, Doyle Lumber Co., Martinsville, Va.; Mr. Frank C. Romano, Jr., president, AGAWAM Associates, Boston, Mass.; and Mr. Thomas J. Perkins, National Venture Capital Association.

Welcome, gentlemen.

Mr. Doyle, as I recall, was a member of the White House Conference on Small Business and spent a lot of time and effort on this matter.

I remember your coming to see me just recently and giving me a briefing on the amount of work that the commission did and the views of the commission, so we are particularly pleased to have you today, Mr. Doyle, along with the other three gentlemen.

I do not know which of you would prefer to go first, but you can decide that among yourselves.

Mr. LEVIN. I am listed first, Mr. Chairman. Good morning.

STATEMENT OF GILBERT LEVIN, PRESIDENT, BIOSPHERICS, INC., ROCKVILLE, MD.

My name is Gilbert Levin, president and founder of Biospherics, Inc. in Rockville, Md. We think of ourselves as an innovative small business. I have been participating in the Small Business Administration Advocacy Task Force for about the past 2 years in studying the decline of innovation in our country, the problems resulting from it, and we have issued a report, many clauses and recommendations of which are now being embodied into one form of legislation or another.

On March 19, I testified before the Senate Small Business Committee in support of S. 1860, the Small Business Innovation Act of 1979 and in summary, I stated that our advocacy task force felt the bill would help return our departed technological leadership to the United States; would help control inflation; produce new jobs; reduce unemployment; improve the quality of jobs; improve our quality of life; help offset the adverse balance of payments in foreign trade; greatly improve the efficiency and cost-effectiveness of Government procurement; provide more tax revenues and improve the international stature of the United States. And this bill would have all of these beneficial effects without any adverse impact on our environment or health. Indeed, one would be hard-pressed to find the risk factor with which to make a risk-benefit analysis.

It was pleasantly surprising, as our task force proceeded, to find that the witnesses we heard expressed virtually no disagreement with the above points. There was remarkable unanimity from all save one, and that was the Department of the Treasury. This was really the only opposition to the recommendations in our report and to the points raised in the bills that your committee is considering today.

It became apparent to us that the Treasury Department representative was wearing fiscal blinders to the fact that minor tax incentives for small innovative businesses and investors in these businesses would ultimately result in a far greater tax base upon the successes of these companies.

I have heard the Department of the Treasury's testimony to our own task force and now before the Congress. As a matter of fact, just yesterday, an Assistant Deputy Secretary from the Treasury testified before Mr. Neal Smith's committee in the House.

Every recommendation proposed to aid innovative small business was opposed by the Treasury Department.

These oppositions, however, are rendered in a very half-hearted way, so that we can tell the people coming to make the statements are under "marching orders." Apparently this morning they refused to march and did not respond to your invitation.

When, as Congressman Smith asked yesterday, they were asked for positive suggestions, they had none to offer as inducements to aid small, innovative business.

They contend that the chief concern is to treat all taxpayers in a "neutral" manner. That word came up again and again—a "neutral manner."

Senator BYRD. I am beginning to wonder whether that White House Conference on Small Business was a public relations gimmick or whether it was really put together for the purpose of accomplishing something. I do not know. I do not want to make that charge, because I just do not know.

But I would think that the Treasury would have ideas that it would want to present since, after all, this was the President's commission. Mr. Doyle was appointed by the President. I recommended him, but the President made the appointment.

The Conference was held under the auspices of the White House.

Mr. LEVIN. Despite that, Mr. Chairman, I think that the Treasury Department has missed the point of the efforts of many people in this country to do something about small, innovative businesses.

The point is not to help small business because somehow it deserves help. This is not a plea on the part of a special interest.

The point is that in this country, for more than a decade, innovation has been declining and this is one of the major roots of our current ills.

Senator BYRD. When innovation declines, productivity declines. The economy declines, and everybody is at a disadvantage, as I see it.

Mr. LEVIN. That is what we are trying to recommend steps to counteract. We want to do something that will help the country as a whole.

It happens that small business creates an inordinate amount of innovation that leads to products. Fortunately, the law of supply and demand applies. The Treasury Department does not see that.

The reward for innovation is simply not great enough now to bring it forth. If tax incentives are required to increase that supply, this is what we ought to do. We must have that supply, and, if we have to pay the price, that is simply the law of supply and demand.

Right now, the tax situation is constraining innovation, as our findings indicated and, therefore, it would be logical to consider changes.

The Treasury Department ought to remember that in all of the small businesses—indeed, in all of the businesses—it is a 50-percent partner with anybody who is successful. From this standpoint, it is hard to believe that tax relief or deferment in amounts as small as $10 million are significant to the national budget as was stated by the Treasury representative at the hearing I attended yesterday.

Senator BYRD. This is a wonderful system we have, really. It is particularly wonderful from the Government's point of view.

The Government gets 50 percent of all the profits and runs none of the risks. Is that not right?

Mr. LEVIN. That is right.

Senator BYRD. What hearing was this yesterday that you were speaking of?

Mr. LEVIN. This was Congressman Neal Smith's hearing, the House Committee on Small Business.

There is a major problem that I would like to stress. You have already mentioned it this morning, Senator Byrd, and it has to do with what constitutes a small business.

None of the bills that you are now considering define the term "small business."

S. 1860, the Small Business Innovation Act, does not approach the matter of small business size. It merely cites a reference stating that size determinations will be made by the Small Business Administration.

I think that would be disastrous. We might gain all of the points we seek in the legislation and then, through administrative interpretation of what a small business is, these benefits will be denied to many of the small businesses.

Senator BYRD. My mind has never been very clear on that. How do you define—where does a business cease to be a small business?

Mr. LEVIN. That is a tough question but, being a small businessman, I have learned to stick my neck out and I have stuck my neck out.

I would take the key from the National Science Foundation Study which found that 50 percent of our major innovations since World War II have been produced by companies with 1,000 or fewer employees, so that would be my cut-off.

Senator BYRD. You would call a company with 1,000 employees small?

Mr. LEVIN. Yes, sir.

We find that, today, there are 31 companies—not industries, but 31 companies, that obtain 60 percent of all the Federal R. & D. dollars contracted. These are the companies against which small business has to compete and they are not small.

Unfortunately, the Norman Rockwell kind of painting of a small business that you might envision is not meaningful in today's economy.

You have heard from the machine tool industry about how much those machine tools cost. Investments must be much heavier today than 10, 20, or 30 years ago and, accordingly, it takes larger businesses than formerly to generate some of the innovative products with which we are seeking to turn our economy around.

In your bills, for example, S. 1967, S. 1481, S. 653, S. 487, S. 110, and S. 2152 are affected by the definition of small business and, in some of those bills, the definition varies as follows:

S. 1860, as I indicated, allows the determination to be made by the SBA about which I will address in a moment. On the other hand, S. 1481 defines, "qualified small business" as "any domestic trade or business the equity capital of which does not exceed $25 million."

And so do S. 653 and S. 487 refer to small businesses as having capital equity up to $25 million. I believe a company of that size would exceed or approach 1,000 employees. My recommendation to the SBA was that a small business should be cut off at the $50 million per year total revenues level, or 1,000 employees, either or both, whichever SBA would choose.

I cannot be certain that this size definition is absolutely correct, but what I would like to show you what might happen with the size standards currently proposed by the Small Business Administration. Over the last several years, there has been so much trouble in defining the size of small business and in the way in which the SBA applies the regulation, that the SBA finally acknowledged last November that it was going to revise the standards.

It stated this in the Federal Register and invited recommendations.

I submitted a letter to the Small Business Administration recommending the size standard I just mentioned. We waited.

On March 10, 1980, this month, the SBA published its Advance Notice of Proposed Rulemaking on size standards. I have attached a copy of that remarkable document to my testimony.

The Small Business Administration adopted the standard industrial code, which was never conceived for the purpose of sizing business, but merely for indicating types of businesses for censuses.

Using that code, the SBA indicated 726 categories of small businesses.

Until now, we have not been overly concerned because the Small Business Administration determined the sizes of business it would aid very long ago. We knew what that size was—it was zero.

We have never been able to get any help from the Small Business Administration. We do not worry about that part of the law.

But under the proposed bills they are going to have authority over every Federal agency contracting with private industry to tell that Federal agency what category of business its procurement must be directed to, and, therefore, the size of company that may bid.

As an example, I have indicated that in a typical RFP for research and development programs on waste disposal, the Small Business Administrator could determine to set that size for a firm of 20 people, or for a firm having as many as 1,000 employees by just changing the category he uses.

I think that is a new intrusion of Government into business.

We have struggled for 13 years now and we have reached gross revenues of $5 million a year. I do not suddenly want to be told we are now a large business ineligible for "Small Business" contracts. Many businesses that we compete with are one or two orders of magnitude larger than we are. In terms of the national economy, we are clearly a small business. To be classified otherwise would gravely affect our ability to win contracts of the type we now normally bid. In my view, this would impede, not help, the course of small business.

I urge, therefore, that your bills define what constitutes a small business and not leave this to the creative imagination of the SBA.

Senator BYRD. I am not sure that this legislation could define it. How many different categories are there?

Mr. LEVIN. 726 with an asterisk. The asterisk footnotes that this does not include all categories.

Senator BYRD. I think the committee and the Congress would have a very difficult time getting a firm definition. It seems to me we have to leave some leeway to the agency but we will certainly take into account your ideas.

I have trouble regarding a $50 million enterprise called a small business, but we will take it into full consideration.

Next witness?

STATEMENT OF WILBUR DOYLE, PRESIDENT, DOYLE LUMBER CO. MARTINSVILLE, VA.

Mr. DOYLE. Senator Byrd and gentlemen, I am Wilbur Doyle, president of Doyle Lumber Co. in Martinsville, Va. We are a small lumber manufacturing company with about 85 people and produce lumber primarily for the housing and furniture industry.

For me, this is a great opportunity to appear before you today and to express some of the concerns that were expressed by small businessmen at the White House Conference.

As has been indicated, I was Senator Byrd's appointee and he asked me to give him a thorough report on what I saw and heard there.

I made the statement that I felt I could capsule the ideas in one sentence, and that was to reduce Government spending, balance the budget, get off our backs and let the free enterprise system function.

Through the discussions, there seemed to be four major themes:

One, small business wants a more favorable climate in which to function.

Two, they want to remove Government interference by removing unnecessary regulation.

Three, Government should use its influence to enhance small business in certain areas such as has been mentioned in the area of research, foreign trade, education and investment and savings.

Four, small business should have a stronger voice in the policy-making area that affects small business.

Participating in the White House Conference was an exciting experience. These 1,700 delegates—who incidentally paid their own ways and insisted on not being reimbursed—seemed to have a remarkably clear understanding of the free enterprise system.

The recommendations coming out of that conference were basic and far reaching. Today, I want to discuss four of the top five just briefly. It will be my goal to help you better understand why these are priority items with small business.

The four items are as follows:

Rework the graduated tax schedule both for corporations and individuals so that the maximum rate is not reached until the $500,000 level.

Senator BYRD. Excuse me, you are talking about $500,000 being the threshold for the top corporate rate?

Mr. DOYLE. Yes, sir.

Reduce the size and spending of the Federal Government and require it to work for the balanced budget.

Revise the estate tax laws to encourage perpetuation of the family-owned business.

Place all regulations in agencies under sunset laws and be certain the action of these agencies are within the scope and action intended by Congress.

In the break-out discussion on capital formation retention, it was obvious that available and affordable capital was the major concern of the delegates. In studying the enclosed work sheet on effective tax rates, it becomes quite evident that although all businesses operate on the same graduated income tax schedule, small business pays a much higher effective tax rate.

There is, Senator Byrd—and I apologize for the quality of it—paperwork gets involved even in reporting and I think I needed about 1,100 pages to come here, so the copier ran weak. But, nevertheless, the work sheets that you have in the back will explain what I am going to say about that.

Let me attempt to explain.

There are, according to these sheets, about 2 million manufacturing firms in this country. 88 percent of those have less than a million dollars in total assets and 1.2 percent have assets of over $10 million.

So basically even if you used $1 million in assets, 88 percent of all manufacturing firms would fall under that.

Now, if you will look in the lefthand column under after-tax profit per dollar of sales, those companies with less than $1 million at 3.4 percent; $1 to $5 million, 3.2 percent; and over $10 million, 7.6 percent.

This figure is very consistent among the small ones, but those firms having over $10 million in assets obviously are faring much better under this even tax system that we have.

Now, this was 1974. This was the period in which the Government previously undertook to control inflation and I want to show by this next chart who took the brunt of that effort to solve it.

In 1976, those firms with $1 to $5 million had essentially the same revenue, after-tax profit 3.5. The $5 million to $10 million had 3.3.

The over-$10 million firms had identically the same, but those 88 percent of all manufacturing firms dropped to 2.9 percent—a 15 to 20-percent drop among the smaller ones.

What I am saying is that the effort by Government to control inflation points out the position that small business is in, and that is that the uniform application of standards does not mean equitable treatment.

If the 1974–76 history repeats itself in this cycle, 88 percent of the corporations in manufacturing will lose from 15 to 20 percent of their after-tax profits, whereas those with $1 million of asset or more will generally be lightly affected.

Next, gentlemen, when we ask for a better environment in which to function, we are not asking for special treatment, only that we receive fair and equitable treatment. You can see by this explanation why small business fall in farther and farther behind in its percentage of the gross national product.

Small businesses are less able to finance long-term projects, have less access to credit, particularly during such as 1974–1976 and again in the one that we are beginning now, whereas the larger corporations are not as adversely affected by these policies and continue on a more steady course.

Certainly a reworking of the graduated income tax schedule as suggested would make it possible for small business to retain more capital that they generate internally. This would allow a small business to expand, to create jobs, to improve productivity and thereby help America fight its No. 1 problem, inflation.

Recommendation No. 2, the delegates agree that inflation was the No. 1 problem. Further, that this problem is caused by excessive Government spending, deficit financing and the printing of money to make the difference.

At the present time, there seems to be considerable interest in a balanced budget. The delegates did not have confidence that that mood would last, and called for a mandatory balanced budget by constitutional amendment.

Senator BYRD. May I say at that point that I think the delegates showed great perception in taking that attitude.

Mr. DOYLE. They also wanted a limitation on spending to 20 percent of gross national product with a gradual reduction to 15 percent. Less Government.

Now, in the last few years, governments, Federal, State and local have been borrowing about $3 out of $4. Therefore, there is only $1 in $4 available to the private sector.

It seems reasonable that balancing the budget would greatly increase the funds available for plant expansion and equipment. Such moneys again would create jobs, improve productivity, increase Government revenue, and make us better able to compete on the world markets.

In my 33 years in the lumber business, we have never reduced the price of lumber unless we had too much lumber. Forced high interest rates may force a recession and a temporary cooling off of inflation. The true solution would come from producing more products and printing less money until a fair balance is reached.

Only then would the consumer benefit from the potential of this great free enterprise system.

The present policy of high interest rates is bankrupting in many small businesses through no fault of their own. For example, last fall we were being told that the housing sector in 1980 would be off 15 percent from 1979. We were further assured by Government officials—and, I might add, Treasury officials—that they recognized what they did to us in the 1974–76 period and certainly did not expect the Senate to do the same thing again.

What has really happened? Exactly the opposite. Higher and higher interest rates have essentially reduced the homebuilding industry to the 1974–75 situation and appears headed for drastically worse.

High interest rates will discourage those who have a choice about borrowing. For those with certificates of deposit, high interest rates may appear to be a blessing.

Many small businesses were heavily in debt when the Government decided to make us pay for their sins. Interest rates went from 10 to 15 percent. The man who was already heavily in debt, found his debt service increased by 50 percent. He could not pay out a debt when the rate was 10 percent. Now he may not be able to survive the 15 percent.

If he does manage to stay in business, his customers will ultimately have to pay this high debt service cost. As always, the consumer pays the bill.

Recommendation three, estate tax law changes were also a principal concern to the delegates. Indications are that four out of five business ventures fail during the first year. Those hearty, innovative ones that survive employ 59 percent of the work force according to the Bureau of the Census for the year 1975 and produce 48 percent of business in gross national product.

These businesses also pay taxes, yet these closely-held small firms quite often are destroyed by estate taxes when a principal dies. In my own experience, we have had many good customers who were ruined by the estate taxes.

Senator BYRD. And inflation, I might add, is going to accentuate that.

Mr. DOYLE. Yes, sir.

Senator BYRD. This committee held hearings on that question this past Monday.

I think it is an extremely important area in which both Congress and the general public should become more interested.

Mr. DOYLE. Well, what happens is when they settle the estate taxes, for one of the principals, they never have sufficient cash flow to pay their bills and operate the company.

The alternate would have been to liquidate the company during the life of the principal, thus destroying jobs and productivity or sell into a large company.

Certainly, our estate tax policy is a disincentive to initiative and productivity. We urge action which would help these small family enterprises survive. They are one of our Nation's great resources.

Recommendation four, finally, there were strong outcries by the delegates to reduce the oppressive hand of Government on small business through excessive regulation. During the debates in Congress as to whether or not to help Chrysler, the point was made that, because Chrysler was so much smaller than Ford and General Motors, the cost of complying with regulations was much, much harder on Chrysler.

This is true. Carry that argument to its logical conclusion and imagine how the inequity multiplies on those of us who are truly small business.

A 200-pound man riding a horse is reasonable. On a pony, the burden is unbearable.

We are the ponies of the manufacturing industry. We urge prompt and decisive action to remedy these inequities.

There are 14 million small businesses in this country. They are owned by 40 million people who are awakening to new hopes and expectations as a political entity. Drastically reducing Government regulations that are unneeded and placing others under sunset review would be greatly appreciated by this large group of deserving constituents.

Gentlemen, in conclusion, let me point out to you that the theme of the recommendations is for less spending, less Government, less regulation, and a balanced Federal Government. The only request for more is not a budget item. What we want, simply, is more economic freedom.

Individual freedom is worthless without it.

Our Nation was founded on these principles, and we urge you and Congress to help us reclaim these ideals.

Thank you, sir.

Senator BYRD. Thank you, Mr. Doyle. The logic and philosophy that you have expressed and summed up in just those few words at the end are so compelling that I feel that they will not be very well accepted around Washington.

But I think the trend is going more in the direction that you and the other members of that 1,700 member group have expressed—it is important that many of these recommendations be adopted. I do not think all of them can be adopted, and certainly it will take some time to adopt any of them.

But I think it gives a good working paper for the Congress. I would hope that some of those, the major ones, at least, could be enacted this year.

I think the political climate is ripe for some changes this year along the line recommended by the White House Conference on Small Business, and I am impressed with what you told the committee that all of the members of that Commission came here at their own expense and did not bill the Government for the cost of coming to Washington. I think that is an example that, if utilized by other groups, could have a very salutary effect throughout our Nation. I think Washington has got to start setting examples, and that is one good example that your group has established and I want to commend you and the other members for taking that action.

Thank you.

Before calling on the next witness, in looking at your figures, on profits of manufacturing corporations, there is one optimistic note, I think, that the effective tax rate in the first two categories, those under $1 million in assets and those between $1 million and $5 million in assets, has been reduced to a degree by 2 percentage points in the first bracket and about 4 percentage points in the second bracket.

Now, the other two go up some.

Mr. DOYLE. I might point out, though, that that was during the 1974 to 1975 period and you can see that there is some probably—these companies were not as profitable during that inflation fighting period, which could have reduced those figures.

Senator BYRD. I see, yes. I had not taken that into consideration.

Mr. DOYLE. I think there is one other point that you might want to say too, and that is that the figures from the very lowest—say in 1976, the effective tax rate on the small business and the biggest companies is fairly uniform, whereas in every other sector, we have got a graduated income and supposedly it is higher on the higher earning groups, but it does not work out that way.

You are paying the smallest company is paying just as much effective tax as the biggest.

Senator BYRD. Well, according to these figures, they are paying more. The effective tax, say, you take on those in $1 to $5 million of assets, the effective tax in 1976 was 42.6 percent and over $10 million in assets, it was 35 percent.

Mr. DOYLE. Precisely. I was taking the bottom group and the top group. It works out that the two who are penalized the heaviest with taxes are the two middle groups, really. The group from $1 to $10 million in total assets are paying the highest bracket of taxes.

The lowest and the highest are paying about the same and those in the middle are paying more.

I think that the reason is——

Senator BYRD. Why is that?

Mr. DOYLE. I think as you pass through a stage into a more productive area, your profitability increases, but you have not reached the point of being able to afford the many perks, so to speak, that might hold taxes down. You are probably more efficient at that point. You do not have as much overhead, and they have not really become as bureaucratic and involved and I think they just do not have the means of deferring, delaying and protecting their revenue.

Senator BYRD. Thank you.

Mr. Romano?

STATEMENT OF FRANK C. ROMANO, JR., PRESIDENT, AGAWAM ASSOCIATES, BOSTON, MASS.

Mr. ROMANO. Good morning, Mr. Chairman. My name is Frank Romano and I am president and treasurer of AGAWAM Associates, a direct response marketing advertising agency located at Rowley, Mass. of approximately 3,200 people about 35 miles north of Boston on the coast.

Senator BYRD. Excuse me, 3,200 people?

Mr. ROMANO. 3,200 people, yes.

We employ 65 people and we had sales last year approximating $3 million.

I am also a member of the board of directors of the Small Business Association of New England and I was a delegate to the White House Conference on Small Business appointed by my Congressman, U.S. Congressman Nicholas Mavroules.

I would like to say in beginning that I fully agree with my fellow delegate, Wilbur Doyle, in his testimony and would like to submit my statement for the record and take my allotted time to give a brief case history of my own personal experience in small business because, again, I fully concur with Mr. Doyle in his comments.

In 1973, I left IBM, determined to go into small business. Prior to that, I had worked for them for 6½ years after graduating from college except for a year and a half leave for service in Vietnam where I had sufficient time to decide what I wanted to do with the rest of my life.

I determined that it was to get out of big business and get into small business. But I found out very quickly that that was a lot easier said than done.

My total savings at that point had been $30,000 through an employee stock option plan that I was able to save. But I still was determined to get into small business and I finally found a company in 1973 and when I found it, the biggest single problem I had was that of capital formation.

Where would I find the money to buy the company with only $30,000?

The first thing I did was go visit many of the local savings banks and commercial banks, and I was turned down. Further, the company that I wanted to buy was owned by a gentleman who had founded the company. He was 67 years of age and he, himself, had had a problem with capital formation because he had been profitable for 20 years but as time went on and technologies changed, he was not able to get the money to buy the equipment he needed to continue to have a profitable business.

This is where I entered in on the scene.

I attempted, as I said before, to visit the banks in the area, to visit the banks in the outlying areas, with no success.

Finally the bank in a neighboring town, after several visits to them, said they would lend me $50,000 and, with my $30,000, I would use that to buy the company, hopefully. However, after 2 weeks of not hearing back from the bank after they had verbally committed, and I called him, and he said to me they had decided against the loan because there was too much of an age difference between the founder, who was 67, and at that time myself, 30 years old.

And we never thought we would ever make it.

Well, Irving Lippoldt was with me until last November when he passed away at 76 and had been a major contributing factor to our success to date.

As we continued to grow, then my only alternative at that point was where did I get the money to buy the business? There did not seem to be any way, so it seemed like my dream of getting into small business was going to go down the drain.

But I finally met with the creditors, because business had been getting worse again because Irving could not get any dollars, and they owed approximately $150,000 in trade debt to both creditors and to the Federal Government and State government for Federal withholding taxes.

I agreed to personally assume that debt, along with that $30,000 and a 5-year employment contract with the founder, and that is how I bought the company. And that was a beginning, really, of where we started.

The next step was where do you get the growth capital to continue to grow?

Again we went back to the banks and again we were turned down. Time after time, I found myself spending most of my time traveling, looking for money to such a point that I had to hire a general manager to run the company because I was no longer able to do it because I was on the road, willing to go visit anybody who would lend us money at any price at any term.

I remember when prime, I think, was at 6 or 7 percent, if somebody would lend me money to buy a piece of equipment at 18 percent, I would sign up so quick the ink would not dry.

That is really, I think, the problem of most of us small businessmen. We just do not have a source of capital and as we look back at that time, as I say again, in looking——

Senator BYRD. Which of these proposed changes in the tax laws would have helped that particular situation?

Mr. ROMANO. Well, there are a couple in front of you today, Senator and one, of course, would be possibly participating debenture. We would have been able to go out and get other investors to come in to lend us money because of the tax advantage they would have got to help us get started.

Possibly I could have got another businessman who was in a similar business to merge with us, or to sell his business and to enter into this business if the capital gains rollover was in effect.

I could have possibly bought some used equipment, if it went to $200,000, the investment tax credit. However, that was not the major issue because most used equipment is difficult to finance and we only bought new equipment because the company who sold it to you would finance it, in most cases.

So those are two direct bills that I see, and tax incentives so at least I could have gone out and got people to come in. Also expanding subchapter S from the 15 to 100 potentially would have given me another area to look at for asking people to invest money.

Senator BYRD. Tell me again, what is your business?

Mr. ROMANO. We are in the direct response advertising agency, Senator.

Senator BYRD. Direct response advertising?

Mr. ROMANO. Yes. We service Fortune 500 companies and our largest client is General Electric, et cetera, and that is the kind of companies we deal with in our small company.

But the biggest problem it seems like always was Fridays with me, because Friday was payday and I tell you, you know, it is amazing, that I was coming down on the plane today and I said, today is Friday and I am still, you know, it leaves an everlasting mark on your mind because when you are struggling for every dollar to make it, and that is one day I think I will hate the rest of my life.

So I found that, again, getting money was just so difficult, and it was only through personal rapport with the local banker and costly going back to him that I finally convinced the local savings bank because we had made our mortgage payments for the first year and a half to give us an additional $60,000 and then another $60,000 which made the biggest single loan they had on their books.

I was later to find out that before he was a bank president he was a small businessman, and that was the only thing, I think, I had going for me.

Subsequent to that, to continue our growth, we finally were able to get a $350,000 line of credit in anticipation of a Farmers Home Administration Government guaranteed loan.

This is basically how we structured the capital formation to get where we are today and I say at best we were truly a totally undercapitalized company and we are here today only because, in my opinion, of luck and just plain tenacity, which just seems to be one of the underlying strong points of a small businessman.

It has been said what we lack in intelligence we make up for in persistence. That also reminds me of a story at IBM when I first joined the company, they told the story of Tom Watson when he was first starting the company, he visited several New York banks asking to borrow $10,000. He was subsequently turned down by all the banks.

He made the trip again and was turned down again. On his third trip to one of the bankers, the banker said, I will lend you the $10,000. He said, it is not because I think your statement is any better than it was the first two times. He just said, I think anybody who is that persistent will probably make it.

In looking at some of the other alternatives we pursued—and, believe me, we looked at every alternative, government guarantees, anything, and one of them was the industrial development bond program that Congress had passed in the 1950's and approximately 38 States have passed that enabling legislation.

It would allow small business to borrow at a reduced prime rate because of the favorable tax-exempt status of the bond. You could borrow at 4 and 5 points below prime over 20 or 30 years.

Now, we worked very hard to get the little town of Rowley at the town meeting to convince them that this was a good program for small business and, after a year of lobbying with the town fathers and the various townspeople, we were able, at a town meeting in May, to get them to pass the enabling legislation and we then had an industrial revenue bond program.

However, I then came to the rude awakening of, who would want to buy AGAWAM Associates bonds?

We are not a publicly traded company. We have no rating. So really the program that Congress put into effect and originally it said that Congress intended primarily to aid small businesses, but critics of IDB's contend that, instead, big and well-heeled companies are getting away with the liberal use of such financing breaks.

And I think there is no question that that is exactly what is happening and a year and a half ago Congress upped the program from a $5 million limit to $10 million.

I basically think the program is an excellent program to stimulate business and I do not think it should be taken away from big business. All I think should happen is that small business should be allowed to access a program like that that would help them to get capital at a reasonable rate over a long term.

In discussing this program with a friend of mine whom I ran into from Solomon Brothers, an investment banking firm who showed some interest in me only because his brother was a small businessman, came up with an idea that if we could attach a Government guarantee like the SBA, Farmers Home or EDA to this program, then the bonds of a small businessman would be marketable and he could borrow money and get into a program that has proven very successful.

And I proposed that at the White House Conference regional delegation for the New England delegates, and it was voted No. 4 in the area of capital formation.

We presently hope to draft a bill and submit it to this session of Congress. We are having Babson College in Wellesley, Mass., do an impact study on it. But it is one of the areas that I feel that certainly, at least in my personal experience, could have been a great help if we could have gotten the dollars.

I think in ending, I would like to say that the first English settlement in America, Jamestown, was established in 1607 by small businessmen and in 1776, when a new Republic, or Commonwealth, was born, it was a system of government fitted to a spirit already developed: risk-taking, independent, innovative.

The simple premise was that if Americans were left free to improve their lot, they would figure out how to do it, and Arthur Levitt, chairman of the White House Conference on Small Business stated, "Small business wants less, not more."

Senator, I hope your earlier comments this morning as to was the White House Conference nothing but a PR stunt will certainly be borne out in the next few years.

I think that there are a lot of us, I am sure, like Mr. Doyle and myself, who are going to make very sure that was not just a PR story.

Senator BYRD. That is fine. That is a good statement that you made and I am most interested in your experience.

I do have to part company with you, however, on the Industrial Development Bonds. I think there has been a lot of abuse in that program.

I do not know why lawyers and doctors, for example, should build their office buildings with tax-exempt bonds. One of the large savings and loans in the area where I live is building a new building with tax-exempt bonds. I frankly just do not approve of them, so that is one part of the White House Conference that I cannot go along with.

Mr. ROMANO. Well, Senator, I would agree with you. I would say, though, if the programs are made available for big business then at least small business ought to get its share of it, or if you feel, as I do——

Senator BYRD. I do not think it should be made available to any of them.

Mr. ROMANO. Then we should do away with the program.

Senator BYRD. I have consistently voted that way. I have voted against increasing the amounts. I think, when I first came here, it was about $1 million. Now it is up to, what, $10 million?

Mr. ROMANO. It is up to $10 million now, yes, sir.

Senator BYRD. Thank you.

Mr. Perkins?

Mr. PERKINS. Thank you. It is a pleasure to be here.

There is probably a little confusion as to whether I should have been on the first panel because I do represent the National Venture Capital Association. On the other hand, I have been an entrepreneur and small businessman so maybe I am on the right panel.

Senator BYRD. You would work in either or both places. You may proceed.

STATEMENT OF THOMAS J. PERKINS, NATIONAL VENTURE CAPITAL ASSOCIATION

Mr. PERKINS. I would like to comment on several of the bills that are before you and particularly S. 2239, which is the incentive option bill, but I would also like to talk about 487, the tax credits; 653, rollover; 2136, the reduced corporate tax rate; and 2168, the subchapter S corporations.

As I said, I am a practicing venture capitalist and I am primarily active in the high technology area and mostly in northern California. I got started as the inventor of one of the early kinds of lasers and subsequently I have been involved in computers and, more recently, in molecular biology.

My partners and I are active investors in about 20 companies and the National Venture Capital Association consists of some 80 member firms which are like ourselves and involved in new venture formation and the development of high growth, innovative companies throughout the United States.

I would like to point out that venture capital investment in total dollars is under $1 billion per year, so we are not in terms that the Government talks about, it is not a lot of money, but the multiplier effect on venture capital investments is absolutely enormous and to give an example, the little laser company I started with $15,000 of savings in effect today is a $100 million business.

Similarly, the computer company we started in 1974 with $1 million is currently running at over a $100 million rate.

And if you look at the so-called Silicon Valley in northern California, which is an enormous industrial complex now, representing the heart of the semiconductor industry and the computer industry, that has largely been started—all of those firms as you drive up and down that area—have been started by venture capital organizations.

A recent study showed that for every dollar of venture capital invested from about 1955 to 1975, the period that we did this study, for every dollar invested, there is a stream of tax revenue to State and local and Federal governments of 30 cents per year, forever.

It really is the golden goose.

Our association has had the restoration of incentive option as one of its highest priorities for several years. Now, we personally do not ever get incentive stock options but it is a tool that we need for the formation of ventures and the tax changes of 1976 eliminated options as one of these tools for the building of new companies.

Now, typically, the businesses we finance, we think they have a lot of potential but they involve a great deal of risk and in order to attract the technical and management talent away from the large companies and into these small, higher risk businesses, we need to offer some incentive and our experience in offering the only stock options that are now available, the so-called nonqualified options—those are the only ones that exist since 1976—has been very bad.

The reason is that the present tax law taxes the difference between the option exercise price and the market value at the time of exercise as income, and it requires that a regular income tax be paid at the time of exercise.

Senator BYRD. Well, that would be a disadvantage, it seems to me, rather than an advantage.

Mr. PERKINS. That is right. That is the present situation.

If we start a company and give individuals a stock option, let us say, at $1 a share and then downstream the individuals exercise those options at, let's say, $5 a share, they have just bought the stock, they then have a paper profit, supposedly, of $4 a share on which they have to pay tax as regular income at the time they exercise the option.

That is the present law.

Senator BYRD. It is not a capital gain, it is ordinary income?

Mr. PERKINS. It is a regular income tax.

Now, frequently the individual does not have the money really to pay that tax and also to exercise the option in the first place, so he has to turn around frequently and sell the stock he has just bought, or a portion of the stock he has bought, in order to pay for the exercise and to pay the tax which is a disincentive. It is exactly the reverse of what you would want.

You would like him to be acquiring ownership in the enterprise and being more closely coupled to it and, instead, you have encouraged him to do just the reverse.

Senator BYRD. How would you change that?

Mr. PERKINS. I will get into that, but what we are suggesting is going back to the way it was really before 1976 and, in fact, all the way back to 1964 and I will explain how that would work.

But you know, there is really something that is much worse. Going back to my example of the stock at $1 and then being exercised at $5 and the tax having to be paid on the $4 of profit, now let's say that the stock loses its value. Something goes wrong with the business and that value goes back down to $1 or maybe 50 cents or 10 cents. So there really was not any profit. In fact, there was no profit. He still has to pay the tax.

The tax is due at the time he exercises the option.

Senator BYRD. He has already paid the tax by that point.

Mr. PERKINS. He has paid the tax, but he never had the profit.

Senator BYRD. He never has the opportunity to recover that if it goes down.

Mr. PERKINS. That is correct.

Now, the curious thing is if the corporation is a profitable corporation and paying taxes at the corporate rate, it gets a deduction equal to the tax that the individual paid.

The theory there is that if it is income to the individual, it must have been a wage paid by the corporation. So it is a deduction for the corporation.

So the net revenue to the Treasury is zero, or essentially zero.

Senator BYRD. What year was that done?

Mr. PERKINS. 1976.

Senator BYRD. That was a great year, was it not?

Mr. PERKINS. A great year.

So I want to emphasize that the revenue to the Treasury is zero under this situation.

So there are some horror stories. I am a director of a corporation that had executives who were officers of the corporation and therefore under the SEC rules when they exercised an option, that is considered the purchase of a stock. By law, they were not able to sell any of that stock for 6 months—this is an SEC rule.

In that intervening 6-month period, the stock market collapsed. The stock dropped below the price that they had exercised the option and they had to pay the tax anyway.

Well, horror stories like these are common and they have given the nonqualified options a very bad reputation, as you might expect.

I know of very few venture capitalists who any longer attempt to use them. Instead, we have to pay salaries competitive with, or usually higher than that offered by the less risky, larger firms, and this has had an inflationary effect on getting the new venture started.

It used to be that typically you might be able to get a top individual, a top manager, out of a large company and possibly he would accept the job in the new enterprise for about 80 percent of what he had been making in the big corporation in return for a significant stock option.

But presently, in order to get him, you would probably have to pay a 20-percent premium in order to attract him away from what he is making.

Now, that is a 40-percent cost, inflationary effect, in starting these new ventures.

So even though the rollback in capital gains taxes in November of 1978 has been of tremendous benefit to us in forming ventures, still we are getting less bang for the buck, so to speak, because we are having to pay higher wages on day one.

If we could have the return of these incentive options, we would be way ahead.

So we urge favorable consideration of S. 2239 which would return the options to the status as it existed in 1964.

Senator BYRD. How did they work in 1964?

Mr. PERKINS. Let's go back to that example of a $1 option exercised—the individual has many years over which to exercise it. Let's say that this stock value goes up to $4 a share and he exercises it.

Nothing happens until he sells the stock.

Now, let's say he sells it at $10 a share. He then pays a capital gains tax on the difference between $1 and $10 so he pays a tax on $9.

Senator BYRD. To me, that seems reasonable.

Mr. PERKINS. We think so, too.

The amazing thing is that the impact on the Treasury is positive. I think maybe this is a first.

We are here to propose something that will actually increase the revenue to the Treasury.

Mr. BYRD. Does the Treasury approve it?

Mr. PERKINS. Treasury has studied this, and agrees with us.

Senator BYRD. Treasury does?

Mr. PERKINS: The Treasury has studied this and agrees with us, yes, indeed.

The Congressional Joint Committee on Taxation asked the Treasury to look at this and the results have come in that it would, indeed, have a positive effect, and the reason is very simple, that the corporation would no longer have the deduction that it presently has under the present law.

You might say this is good for the Treasury, it is good for the venture capitalists, it is good for the individual. Who is losing?

Nobody is losing. Even the shareholders of the corporations are in favor of this change for the very simple reason that if you are going to use stock as incentives for individuals, the fewer number of shares issued will minimize the dilution. So if it is possible to give the individual more that he can really keep, you will not take as many shares if it has a more favorable tax treatment to the individual.

Senator BYRD. More? I do not follow you how you are able to give the individual more than he can really keep?

Mr. PERKINS. No; he is able to keep what you give him. Maybe I said that wrong.

In other words, if 100 share stock option will give the individual, let's say, $10,000 over a reasonable period of time, just to use some numbers, under this tax treatment that we are proposing, he would be able to get the $10,000 with a fewer number of shares because the taxes he would pay would be lower.

So this is less dilutive to all the shareholders and therefore they are in favor of it.

Now, why did the law get changed in the first place? Prior to 1964, the marginal tax rate on earned income was 90 percent and the maximum rate on long-term capital gains was 20 percent.

So pressure existed to provide compensation in the form of options and there were a few documented abuses where individuals were really being paid a salary sort of in the form of stock options because of that tremendous tax difference between the 90-percent rate and the 20-percent rate.

But things have changed. Now the marginal income rate on earned income is 50 percent and the capital gains rate is presently at 28 percent and if under the rules we are proposing we go back to a 2-year holding period before the capital gain would be realized, the pressure, of course, would be tremendously reduced, and also the Securities and Exchange Commission over these many years now requires shareholder approval of all options.

So it is a very democratic thing and we do not feel that there really would be abuses.

Senator BYRD. Well, under the original proposal, it works so long as the market was going up but if the market went down then it——

Mr. PERKINS. That is right, and of course, under any proposal that is true. Just stepping back and looking at the whole thing, we are trying to start companies that will grow and become larger companies. We like to think that we are starting large companies that are just little when we start them.

So if they do grow, and if we are able to attract these kinds of individuals, presumably the value of the stock will go up and they will profit. If it does not happen then they exercise——

Senator BYRD. You consider it a tax shelter, so to speak?

Mr. PERKINS. No; it is not a tax shelter in any way. It is using the capital gains idea rather than a salary idea to provide an incentive for individuals to stay with a firm and to work especially hard to cause the firm to grow.

Senator BYRD. I guess there is this difference, though, is it not? When the stock is sold at capital gains tax of, say, 28 percent, whereas if it were paid in salary it would be at a rate of 50 percent?

Mr. PERKINS. Yes, that is true.

Senator BYRD. So you have got that difference between 28 percent and 50 percent, I assume.

Mr. PERKINS. That is true, but if it is paid in salary, the corporation is taking a deduction equal to the tax that the individual is paid so that the income to the Treasury would——

Senator BYRD. Would be the same or greater?

Mr. PERKINS. It would be greater than what we are proposing, significantly greater.

Senator BYRD. Yes, it would.

Mr. PERKINS. So it does have a positive impact.

I see I have used up my time. The other tax proposals on your agenda we are in favor of all of them. I think that the important thing is that even those that do have a negative impact on the Treasury, it is very small. We are talking about very, very small numbers and to the extent that it encourages venture capital formation, I think you should bear in mind this huge multiplier effect, that every dollar of venture capital can create out into the future. So that we strongly encourage the passage of this bundle of tax measures.

Senator BYRD. Thank you, sir.

Mr. PERKINS. Thank you very much.

Senator BYRD. You know, they say there is a silver lining to every cloud and I can think of a silver lining to the 1969 and 1976 tax reform legislation. As a result of those two pieces of legislation, it has been a couple of years since I have heard the words "tax reform" mentioned around this place.

The bloom is off the rose on tax reform. People have found out that tax reform means a tax increase.

Every speech I have made to the people of Virginia recently I have been telling them to be very careful, very careful, of any legislation with the word "reform" in it, because they are going to get hurt by it, one way or another, whether it be tax reform or welfare reform or labor reform or what have you.

The average citizen is going to bear the brunt of it.

I think this has been a very helpful hearing. The committee appreciates each of your being here today and wants to thank you for the time and effort that you made.

Thank you, and the committee will stand in adjournment.

[The prepared statements of the preceding panel follow:]

SENATE FINANCE COMMITTEE

HEARING ON SMALL BUSINESS MATTERS

Statement of

Gilbert V. Levin, President

Biospherics Incorporated

Rockville, Maryland 20852

March 28, 1980

SUMMARY OF PRINCIPAL POINTS

1. S.1860 and related tax bills foster innovating small business as means toward returning technological leadership and economic progress to U.S.

2. The Bill(s) should define the size of a "small business." A size limit of $50 million per year is revenues and/or 1,000 employees is recommended.

3. Regulatory reporting has become unduly costly to small innovative businesses. The new Bill(s) should carefully control reporting to stop excessive proliferation demanded by Agencies.

Senate Finance Committee

Hearing on Small Business Matters

Statement Of

Gilbert V. Levin, President

Biospherics Incorporated

Rockville, MD 20852

Dirksen Senate Office building

March 28, 1980

Mr. Chairman and Committee members, thank you for inviting me to appear before your Committee on behalf of innovative small businesses. I am President, Chairman of the Board and Founder of Biospherics Incorporated, a small company dedicated to innovative products, processes and services in environmental science and public health. Our innovations include a method for the treatment for municipal wastewater, instruments for monitoring wastewater, a rapid method for the identification of infectious microorganisms, an instrument to measure oil pollution, a patient education kit for the recovery of heart attack victims and a life detection experiment landed on Mars in the NASA Viking Mission.

For approximately two years now, I have participated in studies of the problems besetting innovative small businesses and the decline of innovation in the United States. I was a member of the Small Business Administration Advocacy Task Force and helped draft its report, "Small Business & Innovation," which your Committee received and published in the First Session of the Ninety-Sixth Congress. I am Chairman of Region III of the National Council for Small Business Innovation.

On March 18, I testified before the Senate Small Business Committee in support of S.1860, the Small Business Innovation Act of 1979.

In summary, I reported that the Bill will:

(1) help return technological leadership to the United States,

(2) help control inflation,

(3) produce new jobs,

(4) reduce unemployment,

(5) improve the quality of jobs,

(6) improve our quality of life,

(7) help off-set the adverse balance of payments in foreign trade,

(8) greatly improve the efficiency and cost-effectivness of Government procurement,

(9) provide more tax revenues, and

(10) improve the international stature of the United States.

And further, I believe these desirable affects can be obtained without any adverse impact on our environment or health. Indeed, one would be hard pressed to find the "risk" for a risk-benefit analysis.

There is something very surprising about the basis for this Bill. In our Task Force and in groups which prepared other reports on the subject, there is virtually no disagreement with the above points. Thus, there is remarkable unanimity on this subject. Certainly, the American people regard small business and innovation as time-honored, essential ingredients of the American dream, history and heritage. In fact, the only opposition I have heard is that from the Treasury Department which, apparently, must wear fiscal blinders to the fact that minor tax incentives to small innovative businesses and investors in these businesses will result in a very large increase in the tax base provided by these companies.

I have heard Department of the Treasury testimony regarding this Bill in our own Task Force meetings and before the Congress. In each case, the provisions proposed to give tax concessions to small innovative businesses have been opposed. However, the half-hearted way in which these negative testimonies were delivered clearly showed that the Treasury representative was under "marching orders" to resist any and all proposals in the tax area. When asked for specific positive suggestions, they had none to offer. They contend that the chief concern is to treat all taxpayers in "a neutral manner." I think the Treasury Department has missed the point of the proposed legislation. The point is not to provide tax advantages for small businesses and its investors because small business deserves it. The point is that the United States is in dire trouble because it has lost technological leadership - innovation has been declining for a decade. The law of supply and demand, fortunately, applies. The present business climate simply does not foster innovation. It is essential that the climate be made favorable. Thus, if the tax situation constrains innovation, as our findings indicate, it is logical to consider tax changes that will increase the supply of innovation. The real objective is not to help small business. The objective is to help the United States. Small innovative business can do that, but it requires inducement. Thus, if innovation is essential, those aspects of the tax policy which inhibit it should be modified. The Department of the Treasury should not forget that it is a 50% partner in all profitable businesses. Thus, for an insignificant investment, relative to the Federal budget, the Department of the Treasury could reap highly significant rewards relative to the National debt. This has been clearly shown in studies which have documented the extraordinary record of small innovative businesses in creating taxable jobs, reducing unemployment, bringing overseas dollars back to the U.S., earning profits, and paying taxes.

There is one major problem with all of the Bills aimed at aiding small innovative businesses. ~~S.1860, the~~ Small Business Innovation Act of 1979, unfortunately does not approach the matter of small business size but allows that determination to be made by the SBA. Senate Bills S.2136, S.1967, S.1481, S.653, S.487, S.110, S.2152, all of which you are considering here, are affected by any definition of "small business." No attempt at making the various Bills consistent with respect to defining small business size is evident. Some of the Bills omit any mention of size and S.1860, assigns this responsibility to the SBA. On the other hand, S.1481 defines "qualified small business" as "any domestic trade or business. . . . the equity capital of which does not exceed $25 million . . . . .". S.653 defines "small business stock" as being stock issued by a corporation "the equity capital . . . . of which does not exceed $25 million." The same definition is in S.487.

Because the size standard determination currently administered by the SBA has caused so much confusion and objections among small businesses and contracting agencies alike, the SBA, last year, undertook to develop new size standards. In response to an SBA notice in the Federal Register last November, I submitted the attached letter to Mr. Kulik of the SBA. My recommendation was that the small business size standard be raised to an average of $50 million in revenues per year over the latest 3 year period and that the size standard be reviewed every 5 years to allow for changes in the business world. Since the existing SBA standards involve both revenue amounts and numbers of employees, I also suggested that the average number of employees over the preceeding three years not exceed 1,000 for a company to qualify as a small business. Alternatively, I suggested the SBA might wish to apply both standards.

We waited hopefully over the months. On March 10, 1980, the Small Business Administration published its advanced notice of proposed rule making on size standards. In case you missed this remarkable document, I am attaching a copy (Attachment 1). Contending that the proposed ruling "constitutes a step toward the simplification of Government," the SBA proposes to decide which of 726 categories of small business to apply to each small business and to each set-aside contract proposed by any and all Government agencies! The proposed rules fail the current needs of small innovative businesses on three important fronts: (1) They are overly complex, (2) they give the SBA discriminatory power over all Government agencies contracts with small firms, and (3) a great many of the standard sizes posed are too small for today's world. The fact that the SBA thought it necessary to publish six columns of questions and answers relating to interpretation of the proposed regulations attests to its complexity.

In proposing 726 small business size standards, the SBA carefully footnotes that they do not constitute all U.S. industries! However, the place to examine the proposed rule is in the "Philosophy of Size Standards" published with it. The size standard proper is aimed at "promoting competition." SBA looks at what constitutes a small business in the light of its respective industry - as the SBA sees it. To solve the problems we are addressing, a small business size should be determined with respect to its place in the overall economy. The problem we are addressing for small innovative business is survival, survival against competition from the 31 firms getting 60% of all Federal R&D monies, survival against unfair competition by Government agencies, survival against cash-guzzling taxes, and even survival in the face of the SBA. How will competition be aided, how will innovation be served in the following scenario which could occur under the proposed regulation?

The EPA issues a small business set-aside Request for Proposal for development of a new waste treatment plant for farm waste products. The ultimate authority to determine the category under which the set-aside will be issued is the SBA. Let's examine the discretion which the proposed size standards would give the SBA bureaucrat. A careful scrutiny of the size standards category schedule shows there is no single appropriate category for this important area of innovative technology. However, since the size category schedule must be used, it is possible to distort the following categories to accommodate the proposed project:

Category	Size Standard (maximum number of employees)
7391-Research & Development Laboratories	100
8911-Engineering, Architectural & Surveying Services	50
8091-Health & Allied Services Not Elsewhere Classified	100
4952-Sewerage Systems	50
5084-Industrial Machinery & Equipment	20
3499-Fabricated Metal Products Not Elsewhere Classified	200
3569-General Industrial Machinery Not Elsewhere Classified	200
3599-Machinery, Except Electrical Not Elsewhere Classified	100
3629-Electrical Industrial Apparatus Not Elsewhere Classified	1,000
3699-Electric Machinery, Equipment & Supplies, Not Elsewhere Classified	250

Some of these categories are from inappropriate "Divisions" of categories, but the Divisions will have to be stretched to accommodate the real world. Thus, the bureaucrat can elect to classify the set-aside such that the maximum company size can be established wherever he likes between a minimum of 20 to a maximum of 1,000 employees! However, in the event this does not offer him enough latitude in other cases, he carefully has imposed a Catch-22 into the regulation. It is category 8999-"Services Not Elsewhere Classified." Were he to get specific enough about interpreting almost any detailed procurement, he could make it fall into this category - and limit the size of the company which could respond to the small business set-aside to 25 employees. This system is so arbitrary that it would inflict a greater unfairness than would the designation of an appropriate single size standard for small business.

This constitutes a new intrusion by the SBA into small business affairs. I am not conerned with its administration of size standards with respect to its "assistance" programs. I have long since learned to look elsewhere for assistance. But I am deeply concerned to think the SBA now proposes to decide who may bid for contracts awarded by other Government agencies. At revenues of $5 million per year, I find it hard to imagine that our company is now too large to be eligible for many contracts in a number of its activity areas. Yet, this would be the case were the SBA proposed size standards adopted.

I urge that the Bill or Bills, not the SBA, define the term "small business." I recommend $50 million in revenues per year and/or 1,000 employees, both averaged over a 3 year period as a realistic, simple size standard for today's world. In its now famous study, the National Science Foundation found that half of our most significant new industrial products and processes came from firms with up to 1,000 employees. Firms having up to 100 employees contributed 24% of these innovations. As seen in my hypothetical example, which will become real life should the proposed size standards be adopted, most of the innovative companies could be eliminated from consideration for set-asides. I do not believe this your objective.

The final specific item I wish to call to your attention is that dealing with regulations requiring reporting by small businesses. Congressional Acts, of course, require that the responsibility to administer the new law be given to an Agency. It, therefore, seems perfectly reasonable that the Bill contain language such as, "the Agency shall issue whatever regulations it deems appropriate to administer the Act" or words to that affect. This seems reasonable language, but, when interpreted by unreasonable bureaucrats, it is construed out of all intent of the Congress. To illustrate this matter, I have had a list prepared of the reporting that our small firm, grossing just $5 million in revenues per year, must submit in the course of a year (Attachment 2). I suspected the reporting problem was getting worse, because, increasingly, when I needed accounting information, I found it had to be delayed because our people were preparing Agency required reports to meet deadlines. But, even I was surprised to learn that, in the course of last year, our company prepared 130 such reports totalling 315 pages. One of the most difficult is the "Small Business and Small Disadvantaged Business Contracting Plan Report." This extensive report requires we obtain information on matters not within our corporate purview. Responding to these requirements has become very costly and interferes with the close day-to-day attention management must give to a small business. I ask that you carefully consider this problem whenever you are tempted to insert words such as "the Agency shall make appropriate regulations. . . ." and that, instead you indicate precisely what reporting is required - and keep it reasonable.

I think that the Bills under consideration, hopefully with the changes suggested above, would have a major, positive impact upon small innovative businesses and, in fairly short order, would become an important factor in returning technological leadership to the United States. With other appropriate actions by the Congress, this all-important objective can be achieved in time to prevent the progressive decline of our quality of life to the point of no return.

ATTACHMENT I

federal register

Monday
March 10, 1980

Part II

Small Business Administration

Revision to Method of Establishing Size Standards and Definitions of Small Business

15442 Federal Register / Vol. 45, No. 48 / Monday, March 10, 1980 / Proposed Rules

SMALL BUSINESS ADMINISTRATION

13 CFR Part 121

Small Business Size Standards; Revision to Method of Establishing Size Standards and Definitions of Small Business

AGENCY: Small Business Administration.

ACTION: Advance Notice of Proposed Rulemaking.

SUMMARY: The Small Business Administration is proposing an amendment to its size standard regulations which affect eligibility for SBA programs. The revision is designed to update and improve the logic, methodology, and presentation of the size standard procedures. The proposed regulation will simplify SBA programs for the small business community, reduce administrative complexity, and increase the effectiveness of SBA programs by improved targeting of its resources.

DATE: Written comments must be submitted by May 9, 1980.

ADDRESS ALL COMMENTS TO: Kaleel C. Skeirik, Chief, Size Standards Division, Small Business Administration, 1441 L Street, N.W., Room 800, Washington, DC 20416.

FOR FURTHER INFORMATION CONTACT: Kaleel C. Skeirik, (202) 653-6373

SUPPLEMENTAL INFORMATION:

Highlights of Proposed Regulations

1. Size standards are intended to enhance competition and promote entry.
2. Size standards are established by industry based on a consistent overall philosophy.
3. The data and methodology used to develop size standards are current and well documented.
4. Each designated industry size standard will be used for all SBA programs.
5. Only one measure of a firm's size is used.
6. The size standard regulations and procedures are simplified.

Philosophy of Size Standards

> The essence of the American system of private enterprise is free competition. . . . The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise. . .
>
> Small Business Act, Section 2(a)

To implement this policy Congress established the Small Business Administration (SBA) and gave it the responsibility to administer a range of programs designed to achieve these goals. Eligibility for SBA programs requires that a firm be "small." Establishing "size standards," i.e., the precise specification of "small," is delegated to the Administrator of the SBA.[1]

SBA's proposed size standards rest upon two premises. The first is that what constitutes a "small" business is different in different industries; regardless of how one measures the size of a business, e.g., number of employees, dollar volume of receipts, there is large interindustry variation. Second, that the resources of the SBA, given to it by taxpayers through the Congress, should be used to assist small business in order to enhance the intensity of competition in the U.S. economy.

The legislative history of the Small Business Act demonstrates that size standards must be established in the context of the industrial structure of the U.S. economy. The national economy is made up of hundreds of different industries, each one possessing its own unique characteristics, history, and dynamics. For the purposes of simplicity each industry can be classified by its degree of "competition."

The use of the term "competition" is very important to understanding the policy role of size standards. There are at least three different ways in which the term competition is used. First, there is the notion of business rivalry, of individual firms competing for sales. Usually, this is what a businessman thinks of when he speaks of competition. In this sense, most businesses compete. A second sense in which competition is used is in Government procurement, viz., competitive bidding. In this instance, a number of firms bid for contracts, either in open competition (between firms both large and small) or under set-asides where only small firms may enter into the competitive bidding. Third, there is the professional economist's meaning of competition. For the economist, competition takes place for an industry as a whole, not for individual firms: an industry is competitive when no single firm, or group of firms, is able to exert any control over the price of their product. Thus, farming or the construction industry is competitive; the automobile manufacturing industry is not.

In setting size standards the economist's idea of competition is used. Each individual industry was, initially, placed into one of three broad categories of industry: "competitive," "concentrated," and "mixed." The group of concentrated industries is characterized by a highly unequal distribution of sales among the firms in the industry, e.g., the four largest firms accounting for more than half the industry's sales. Competitive industries display a more equal distribution of sales, and the average firm is relatively small when measured by annual sales or number of employees. The group of mixed industries is the residual, viz., those industries which did not meet the criteria of competitive or concentrated industries. The study which led to the development of the size standards found 317 competitive industries, 160 concentrated industries, and 249 mixed industries.[2]

Given this classification of industries, the question now becomes which firms in each industry (or group of industries) shall be made eligible for SBA programs. Because the Small Business Act precludes SBA assistance to firms which "are dominant" in their industries, establishing a size standard in concentrated industries is a straightforward task—simply identify and exclude those few firms which account for a disproportionately large share of the industry's sales. This could enhance competition by providing support to all firms, i.e., these concentrated industries, except the dominant ones.[3]

In industries which currently exhibit an intense level of competition, does any justification for SBA intervention exist? Historically, SBA has accepted the idea that the smallest businesses, regardless of their industry, are worthy of support. This has been justified on the grounds that it is a positive social, economic, and political act to provide opportunity for entry into the business world. Individual initiatives toward entrepreneurship should be encouraged by the Federal Government and meeting this responsibility is part of the mission of SBA. In such competitive industries size standards should be set relatively low, so as to support entry and moderate growth. Because such industries are already competitive, SBA

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[1] Size standards only define eligibility for SBA programs. SBA strongly urges that its resources and its experience be utilized in developing definitions of "small" business that are responsive to the statutory missions of other Federal agencies and which are accurate reflections of the realities of the small business sector.

[2] While these 726 industries do not constitute all U.S. industries, they do comprise the traditional clientele of the SBA.

[3] The SBA is neither equipped nor desirous of excluding firms whose size exceeds some absolute size, e.g., 1,000 employees. This is a minor adjustment to this proposition.

intervention will not necessarily enhance competition.

The SBA role in mixed industries requires high size standards be set so as to carry out its legislative mandate to enhance competition. By making available its programs to those firms whose very presence acts as a constraint on the anticompetitive behavior of larger firms, SBA can reinforce competition and offset the pressures to increase the degree of concentration in these industries. Some of the mixed industries are experiencing significant changes in their market structures and display increasing concentration. SBA's intervention in these industries will be designed to maintain competition.

It is the view of SBA that firms which meet size standards and are eligible for SBA programs be given prompt and effective assistance. Small business concerns should not become dependent on continuing assistance under the Small Business Act from the "cradle to the grave" but should plan for the day on which they can thrive without such assistance.

Data and Methodology

The process of transposing this philosophy to numerical size standards for individual industries is a complex one. The basic sources of data used in establishing size standards include: *the Standard Industrial Classification Manual*, which is used as a guide in defining industries; U.S. Bureau of the Census, *Concentration Ratios in Manufacturing*, and *Enterprise Statistics*; a special tabulation of the *1972 Enterprise Statistics* prepared for SBA by the U.S. Bureau of the Census; U.S. Department of Commerce, *U.S. Industrial Outlook* and *Survey of Current Business*; Internal Revenue Service, *Statistics of Income*; Dun and Bradstreet's *DMI Market Profile*; Economic Information Service's *Marketing Information*; SBA's own extensive files of articles and correspondence on individual industries and information provided by trade associations. From these data sources, several measures of each industry's structure are available. The factors examined for the purpose of setting size standards included, average firm size, the extent of industry dominance by large firms as described by the concentration ratio and the Herfindahl index, the number of firms, the distribution of sales and employees among the firms in the industry, and the nature of entry barriers. The development of size standards is not an exact quantitative procedure. No single measure or simple numerical device was used to establish an industry's size standard. The process can be described as an exercise of informed judgment based on the policy considerations described above, viz., setting high size standards in concentrated and mixed industries in order to include larger firms so as to sustain and enhance competition, while setting size standards low in competitive industries tend to assure the opportunities for entry and to protect the smallest business.[4]

A Single Size Standard

A single size standard is proposed for all SBA programs. This constitutes a step toward the simplification of Government. Currently, there are separate size standard eligibility criteria among SBA programs. This leads to confusion for small businesses needing assistance, complexity for SBA employees responsible for administering its programs, and severe criticism by those who have studied SBA's size standards. Moreover, moving to a single size standard will eliminate the anomalous situation where a particular business firm is defined as "small" and eligible for assistance through one SBA program and not "small" and hence ineligible for assistance through another program.

One Measure of Size

All proposed size standards are stated in terms of a firm's number of employees. This is an improvement over the current system which uses many different measures of a business' size.

SBA has found that when size standards are denominated in dollars, i.e., annual revenues, its ability to help the small business sector is undermined by inflation. Using employment, as opposed to dollar sales, will provide greater stability for SBA and its clients; will remove interindustry distortions generated by differential inflation rates; and reduce the need for SBA to make frequent revisions in the size standards merely to reflect price increases.

Implementation Plan

SBA appreciates the fact that in some industries, and for some programs, the proposed size standards constitute a major change in their business environment. To be most responsive to the requirements of the small business sector SBA is not proposing a schedule for the implementation of the proposed size standards. Rather we invite your comments on the merits of alternative implementation schemes. Included among issues under consideration are: should the implementation timetable be the same for all SBA programs; should industries where the size standard has been raised be treated the same as industries where the size standard has been lowered; should implementation be scheduled on an incremental basis or take effect at one time; what should be the total length of time before all new size standards are put into effect; should different industries be given different amounts of time to comply with the new size standards.

Future Study

SBA's proposed size standards should not be viewed as permanent but rather as an ongoing process. SBA must be responsive to the dynamic structural changes constantly occurring in the economy as well as the changing needs of the small business community. Furthermore, SBA must strive to improve the accuracy and timeliness of the data, the level of analytical sophistication, and the quality of judgment brought to bear on the problems of setting size standards. Among the areas for future study being considered by the SBA are: an analysis of trends and projections of the patterns of concentration in U.S. industries; a study of differential entry and growth requirements among industries and their implication for SBA.

Comments

The proposed size standards are a major departure from SBA's "business as usual" posture. We strongly believe that this proposal will strengthen both the small business community and the SBA. The designation of particular size standards in individual industries is of concern to SBA, and we invite comments from all affected parties. However, we hope that public attention is also paid to the logic, philosophy, and design of the size standards. For the ability of the SBA to carry out its statutory mission requires an accurate reading of the statute and its legislative history, a reasoned application of SBA's mandate to the myriad empirical complexities of the U.S. economy, judicious appreciation of the strengths and limitations of SBA's programs, and a strong commitment to the success of the small business community.

Regional Hearings

In view of the fact that the proposed size standards include significant changes and are comprehensive in scope, the SBA expects to conduct public regional hearings during the time

[4] A comprehensive technical discussion of the concepts, data, and methodology is contained in The Size Standards Study. To obtain a copy contact: Chief, Size Standards Division, Small Business Administration, 1441 L Street, N.W., Washington, D.C. 20416. (202) [illegible].

the proposed revised regulations are published for public comment in the Federal Register.

Accordingly, pursuant to Section 3 and 5(b)(6) of the Small Business Act, as amended (15 U.S.C. 632, 634), it is proposed to amend Part 121 of Title 13 of the Code of Federal Regulations as follows:

(1) By redesignating § 121.3-2 as § 121.6.

(2) By redesignating § 121.3-4 as § 121.7.

(3) By redesignating § 121.3-5 as § 121.8.

(4) By redesignating § 121.3-6 as § 121.9.

(5) By deleting § 121.3, § 121.3-1, § 121.3-3, § 121.3-7, § 121.3-8, § 121.3-9, § 121.3-10 through § 121.3-16 and Schedules A through L.

(6) By adding § 121.1 through § 121.5, and set forth below.

(7) The Table of Contents for Part 121 reads as set forth below:

PART 121—SMALL BUSINESS SIZE STANDARDS

Sec.

Subpart A—Background

§ 121.1 Purpose and method of establishing size standards.

The essence of the American system of private enterprise is free competition. . . . The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise. . . .

Small Business Act, Section 2(a)

(a) To implement this policy Congress established the Small Business Administration (SBA) and gave it the responsibility to administer a range of programs designed to achieve these goals. Eligibility for SBA programs requires that a firm be "small." Establishing "size standards," i.e., the precise specification of "small," is delegated to the Administrator of the SBA.[1]

(b) SBA's size standards rest upon two premises. The first is that what constitutes a "small" business is different in different industries; regardless of how one measures the size of a business, e.g., number of employees, dollar volume of receipts, there is large interindustry variation. Second, that the resources of the SBA, given to it by taxpayers through the Congress, should be used to assist small business in order to enhance the intensity of competition in the U.S. economy.

(c) The legislative history of the Small Business Act demonstrates that size standards must be established in the context of the industrial structure of the U.S. economy. The national economy is made up of hundreds of different industries, each one possessing its own unique characteristics, history, and dynamics. For the purposes of simplicity each industry can be classified by its degree of "competition."

(d) The use of the term "competition" is very important to understanding the policy role of size standards. There are at least three different ways in which the term competition is used. First, there is the notion of business rivalry, of individual firms competing for sales. Usually, this is what a businessman thinks of when he speaks of competition. In this sense, most businesses compete. A second sense in which competition is used is in Government procurement, viz., competitive bidding. In this instance, a number of firms bid for contracts either in open competition (between firms both large and small) or under set-asides where only small firms may enter into the competitive bidding. Third, there is the professional economist's meaning of competition. For the economist competition takes place for an industry as a whole, not for individual firms. An industry is competitive when no single firm or group of firms is able to exert any control over the price of their product. Thus, farming or the construction industry is competitive, the automobile manufacturing industry is not.

(e) In setting size standards the economist's idea of competition is used. Each individual industry was, initially, placed into one of three broad categories of industry: "competitive," "concentrated," and "mixed." The group of concentrated industries is characterized by a highly unequal distribution of sales among the firms in the industry, e.g., the four largest firms accounting for more than half the industry's sales. Competitive industries display a more equal distribution of sales and the average firm is relatively small when measured by annual sales or number of employees. The group of mixed industries is the residual, viz., those which did not meet the criteria of competitive or concentrated industries. The study which led to the development of the size standards found 317 competitive industries, 100 concentrated industries, and 260 mixed industries.[2]

(f) Given this classification of industries, the question now becomes which firms in each industry (or group of industries) shall be made eligible for SBA programs. Because the Small Business Act precludes SBA assistance to firms which "are dominant" in their industries, establishing a size standard on concentrated industries is a straightforward task—simply identify and exclude those few firms which account for a disproportionately large share of the industry's sales. This could enhance competition by providing support to all firms, in these concentrated industries, except the dominant ones.[3]

(g) In industries which currently exhibit an intense level of competition, does any justification for SBA intervention exist? Historically, SBA has accepted the idea that the smallest businesses, regardless of their industry, are worthy of support. This has been justified on the grounds that it is a positive social, economic, and political act to provide opportunity for entry into the business world. Individual initiatives toward entrepreneurship should be encouraged by the Federal Government and meeting this responsibility is part of the mission of SBA. In such competitive industries size standards should be set relatively low, so as to support entry and moderate growth. Because such industries are already competitive SBA intervention will not necessarily enhance competition.

[1] Size standards only define eligibility for SBA programs. SBA strongly urges that its resources and its experience be utilized in developing definitions of "small" business that are responsive to the statutory missions of other Federal agencies and which are accurate reflections of the realities of the small business sector.

[2] While these [illegible] industries do not constitute all U.S. industries, they do comprise the traditional clientele of the SBA.

[3] The SBA is neither equipped nor desirous of certifying firms whose size exceeds some absolute size, say [illegible] employees. This is a minor adjustment to this proposition.

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(h) The SBA role in mixed industries requires high size standards be set so as to carry out its legislative mandate to enhance competition. By making available its programs to those firms whose very presence acts as a constraint on the anticompetitive behavior of larger firms, SBA can reinforce competition and offset the pressures to increase the degree of concentration in these industries. Some of the mixed industries are experiencing significant changes in their market structures and display increasing concentration. SBA's intervention in these industries will be designed to maintain competition.

(i) The process of transposing this philosophy to numerical size standards for individual industries is a complex one. The basic sources of data used in establishing size standards include: the *Standard Industrial Classification Manual*, which is used as a guide in defining industries; U.S. Bureau of the Census, *Concentration Ratios in Manufacturing*, and *Enterprise Statistics*; a special tabulation of the *1972 Enterprise Statistics* prepared for SBA by the U.S. Bureau of the Census; U.S. Department of Commerce, *U.S. Industrial Outlook* and *Survey of Current Business*; Internal Revenue Service, *Statistics of Income*; Dun and Bradstreet's *DMI Market Profile*; Economic Information Service's *Marketing Information*; SBA's own extensive files of articles and correspondence on individual industries and information provided by trade associations.

(j) From these data sources several measures of each industry's structure are available. The factors examined for the purpose of setting size standards included: average firm size, the extent of industry dominance by large firms as described by the concentration ratio and the Herfindahl index, the number of firms, the distribution of sales and employees among the firms in the industry, and the nature of entry barriers. The development of size standards is not an exact quantitative procedure. No single measure or simple numerical device was used to establish an industry's size standard. The process can be described as an exercise of informed judgement based on the policy considerations described above, viz., setting high size standards in concentrated and mixed industries in order to include larger firms so as to sustain and enhance competition, while setting size standards low in competitive industries tends to assure the opportunities for entry and to protect the smallest businesses.

(k) It is the view of SBA that firms which meet size standards and are eligible for SBA programs be given prompt and effective assistance. Small business concerns should not become dependent on continuing assistance under the Small Business Act from the cradle to the grave but should plan for the day on which they can thrive without such assistance.

Subpart B—Definition of Small Business

§ 121.2 Standard industrial classifications and employee size standards.

The size standards for all the manufacturing and nonmanufacturing industries (except for agriculture) are on employment basis. The following size standards are to be used when determining the size status of applicants for all SBA assistance programs, except sales of Government property.

SIC	Description	Size of standards (No. of employees)
Div. A	Agriculture (see size standards at end of section)	
Div. B	Mining	
	Major Group 10—Metal Mining	
[illegible]	Iron Ores	[illegible]
[illegible]	Copper Ores	[illegible]
[illegible]	Lead and Zinc Ores	[illegible]
[illegible]	Gold Ores	[illegible]
[illegible]	Silver Ores	[illegible]
[illegible]	Bauxite and Other Aluminum Ores	[illegible]
[illegible]	Ferroalloy Ores, Except Vanadium	[illegible]
[illegible]	Metal Mining Services	[illegible]
[illegible]	Mercury Ores	[illegible]
[illegible]	Uranium-Radium-Vanadium Ores	[illegible]
[illegible]	Metal Ores, Not Elsewhere Classified	[illegible]
	Major Group 11—Anthracite Mining	
1111	Anthracite	[illegible]
[illegible]	Anthracite Mining Services	[illegible]
	Major Group 12—Bituminous Coal and Lignite Mining	
[illegible]	Bituminous Coal and Lignite	[illegible]
[illegible]	Bituminous Coal and Lignite Mining Services	[illegible]
	Major Group 13—Oil and Gas Extraction	
[illegible]	Crude Petroleum and Natural Gas	[illegible]
[illegible]	Natural Gas Liquids	[illegible]
1381	Drilling Oil and Gas Wells	[illegible]
[illegible]	Oil and Gas Field Exploration Services	[illegible]
[illegible]	Oil and Gas Field Services, Not Elsewhere Classified	[illegible]
	Major Group 14—Mining and Quarrying of Non-Metallic Minerals, Except Fuels	
1411	Dimension Stone	[illegible]
[illegible]	Crushed and Broken Limestone	[illegible]
[illegible]	Crushed and Broken Granite	[illegible]
[illegible]	Crushed and Broken Stone, Not Elsewhere Classified	[illegible]
[illegible]	Construction Sand and Gravel	[illegible]
[illegible]	Industrial Sand	[illegible]
[illegible]	Bentonite	[illegible]
[illegible]	Fire Clay	[illegible]
[illegible]	Fuller's Earth	[illegible]
[illegible]	Kaolin and Ball Clay	[illegible]
[illegible]	Clay, Ceramic, and Refractory Minerals, Not Elsewhere Classified	[illegible]
[illegible]	Barite	[illegible]
[illegible]	Fluorspar	[illegible]
1474	Potash, Soda, and Borate Minerals	[illegible]
[illegible]	Phosphate Rock	[illegible]
1476	Rock Salt	[illegible]
1477	Sulfur	[illegible]
1479	Chemical and Fertilizer Mineral Mining, Not Elsewhere Classified	1,000
[illegible]	Non-metallic Minerals (Except Fuels) Services	[illegible]
[illegible]	Gypsum	[illegible]
[illegible]	Talc, Soapstone, and Pyrophyllite	[illegible]
[illegible]	Miscellaneous Nonmetallic Minerals, Not Elsewhere Classified	[illegible]
Div. C	Construction	
	Major Group 15—Building Construction—General Contractors and Operative Builders	
[illegible]	General Contractors—Single-Family Houses	[illegible]
[illegible]	General Contractors—Residential Buildings, Other Than Single-Family	[illegible]
[illegible]	Operative Builders	[illegible]
[illegible]	General Contractors—Industrial Buildings and Warehouses	[illegible]
[illegible]	General Contractors—Nonresidential Buildings, Other Than Industrial Buildings, and Warehouses	[illegible]
	Major Group 16—Construction Other Than Building Construction—General Contractors	
16[illegible]	Highway and Street Construction, Except Elevated Highways	[illegible]
[illegible]	Bridge, Tunnel, and Elevated Highway Construction	[illegible]
[illegible]	Water, Sewer Pipe Line, Communication and Power Line Construction	[illegible]
[illegible]	Heavy Construction, Not Elsewhere Classified, Except Dredging	[illegible]
[illegible]	Dredging	[illegible]
	Major Group 17—Construction—Special Trade Contractors	
17[illegible]	Plumbing, Heating (Except Electric), and Air Conditioning	[illegible]
17[illegible]	Painting, Paper Hanging, and Decorating	[illegible]
17[illegible]	Electrical Work	[illegible]
17[illegible]	Masonry, Stone Setting, and Other Stonework	[illegible]
17[illegible]	Plastering, Drywall, Acoustical and Insulation Work	[illegible]
17[illegible]	Terrazzo, Tile, Marble and Mosaic Work	[illegible]
1751	Carpentering	[illegible]
17[illegible]	Floor Laying and Other Floorwork, Not Elsewhere Classified	[illegible]
1761	Roofing and Sheet Metal Work	[illegible]
1771	Concrete Work	[illegible]
1781	Water Well Drilling	[illegible]
17[illegible]	Structural Steel Erection	[illegible]
17[illegible]	Glass and Glazing Work	[illegible]
1794	Excavating and Foundation Work	[illegible]
17[illegible]	Wrecking and Demolition Work	[illegible]
17[illegible]	Installation or Erection of Building Equipment, Not Elsewhere Classified	[illegible]
1799	Special Trade Contractors, Not Elsewhere Classified	[illegible]
Div. D	Manufacturing	
	Major Group 20—Food and Kindred Products	
[illegible]	Meat Packing Plants	[illegible]
[illegible]	Sausages and Other Prepared Meat Products	[illegible]
2016	Poultry Dressing Plants	[illegible]
2017	Poultry and Egg Processing	[illegible]

495

Major Group 2[illegible]—Printing, Publishing, and Allied Industries

[illegible]	Creamery Butter	1,000
[illegible]	Cheese, Natural and Processed	1,000
[illegible]	Condensed and Evaporated Milk	2,500
[illegible]	Ice Cream and Frozen Desserts	[illegible]
[illegible]	Fluid Milk	500
[illegible]	Canned Specialties	[illegible]
[illegible]	Canned Fruits, Vegetables, Preserves, Jams, and Jellies	[illegible]
[illegible]	Dried and Dehydrated Fruits, Vegetables, and Soup Mixes	750
[illegible]	Pickled Fruits and Vegetables, Vegetable Sauces and Seasonings, and Salad Dressings	[illegible]
[illegible]	Frozen Fruit, Fruit Juices and Vegetables	[illegible]
[illegible]	Frozen Specialties	[illegible]
[illegible]	Flour and Other Grain Mill Products	1,000
[illegible]	Cereal Breakfast Foods	[illegible]
[illegible]	Rice Milling	[illegible]
[illegible]	Blended and Prepared Flour	[illegible]
[illegible]	Wet Corn Milling	[illegible]
[illegible]	Dog, Cat, and Other Pet Food	[illegible]
[illegible]	Prepared Feeds and Feed Ingredients for Animals and Fowls, Not Elsewhere Classified	[illegible]
[illegible]	Bread and Other Bakery Products, Except Cookies and Crackers	[illegible]
[illegible]	Cookies and Crackers	[illegible]
[illegible]	Cane Sugar, Except Refining Only	[illegible]
[illegible]	Cane Sugar Refining	[illegible]
[illegible]	Beet Sugar	[illegible]
[illegible]	Candy and Other Confectionery Products	[illegible]
[illegible]	Chocolate and Cocoa Products	[illegible]
[illegible]	Chewing Gum	[illegible]
[illegible]	Cottonseed Oil Mills	1,000
[illegible]	Soybean Oil Mills	[illegible]
[illegible]	Vegetable Oil Mills, Except Corn, Cottonseed, and Soybean	[illegible]
[illegible]	Animal and Marine Fats and Oils	[illegible]
[illegible]	Shortening, Table Oils, Margarine and Other Edible Fats and Oils, Not Elsewhere Classified	[illegible]
[illegible]	Malt Beverages	[illegible]
[illegible]	Malt	[illegible]
[illegible]	Wines, Brandy, and Brandy Spirits	[illegible]
[illegible]	Distilled, Rectified, and Blended Liquors	[illegible]
[illegible]	Bottled and Canned Soft Drinks and Carbonated Waters	[illegible]
[illegible]	Flavoring Extracts and Flavoring Sirups, Not Elsewhere Classified	[illegible]
[illegible]	Canned and Cured Fish and Seafoods	[illegible]
[illegible]	Fresh or Frozen Packaged Fish and Seafoods	[illegible]
[illegible]	Roasted Coffee	[illegible]
[illegible]	Manufactured Ice	[illegible]
[illegible]	Macaroni, Spaghetti, Vermicelli, and Noodles	[illegible]
[illegible]	Food Preparations, Not Elsewhere Classified	[illegible]

Major Group 21—Tobacco Manufactures

2111	Cigarettes	[illegible]
2121	Cigars	[illegible]
2131	Tobacco (Chewing and Smoking) and Snuff	[illegible]
2141	Tobacco Stemming and Redrying	[illegible]

Major Group 22—Textile Mill Products

2211	Broad Woven Fabric Mills, Cotton	[illegible]
2221	Broad Woven Fabric Mills, Man-Made Fiber and Silk	[illegible]
[illegible]	Broad Woven Fabric Mills, Wool (Including Dyeing and Finishing)	[illegible]
2241	Narrow Fabrics and Other Smallwares Mills: Cotton, Wool, Silk, and Man-Made Fiber	[illegible]
[illegible]	Women's Full Length and Knee Length Hosiery	[illegible]
[illegible]	Hosiery, Except Women's Full Length and Knee Length Hosiery	[illegible]
[illegible]	Knit Outerwear Mills	[illegible]
[illegible]	Knit Underwear Mills	[illegible]
[illegible]	Circular Knit Fabric Mills	[illegible]
[illegible]	Warp Knit Fabric Mills	[illegible]
[illegible]	Knitting Mills, Not Elsewhere Classified	[illegible]

Major Group 22—Textile Mill Products

[illegible]	Finishers of Broad Woven Fabrics of Cotton	[illegible]
[illegible]	Finishers of Broad Woven Fabrics of Man-Made Fiber and Silk	[illegible]
[illegible]	Finishers of Textiles, Not Elsewhere Classified	750
2271	Woven Carpets and Rugs	[illegible]
2272	Tufted Carpets and Rugs	[illegible]
2279	Carpets and Rugs, Not Elsewhere Classified	[illegible]
[illegible]	Yarn Spinning Mills: Cotton, Man-Made Fibers, and Silk	[illegible]
[illegible]	Yarn Texturizing, Throwing, Twisting, and Winding Mills: Cotton, Man-Made Fibers, and Silk	[illegible]
[illegible]	Yarn Mills, Wool, Including Carpet and Rug Yarn	[illegible]
[illegible]	Thread Mills	[illegible]
[illegible]	Felt Goods, Except Woven Felts and Hats	[illegible]
[illegible]	Lace Goods	[illegible]
[illegible]	Paddings and Upholstery Filling	[illegible]
[illegible]	Processed Waste and Recovered Fibers and Flock	[illegible]
[illegible]	Coated Fabrics, Not Rubberized	[illegible]
[illegible]	Tire Cord and Fabric	[illegible]
[illegible]	Nonwoven Fabrics	[illegible]
[illegible]	Cordage and Twine	[illegible]
[illegible]	Textile Goods, Not Elsewhere Classified	[illegible]

Major Group 23—Apparel and Other Finished Products Made from Fabrics and Similar Materials

2311	Men's, Youths', and Boys' Suits (Except Work Shirts) and Nightwear	[illegible]
2321	Men's, Youths', and Boys' Shirts (Except Work Shirts) and Nightwear	[illegible]
[illegible]	Men's, Youths', and Boys' Underwear	[illegible]
[illegible]	Men's, Youths', and Boys' Neckwear	[illegible]
2327	Men's, Youths', and Boys' Separate Trousers	[illegible]
[illegible]	Men's, Youths', and Boys' Work Clothing	[illegible]
[illegible]	Men's, Youths', and Boys' Clothing, Not Elsewhere Classified	[illegible]
[illegible]	Women's, Misses', and Juniors' Blouses, Waists, and Shirts	[illegible]
[illegible]	Women's, Misses', and Juniors' Dresses	[illegible]
2337	Women's, Misses', and Juniors' Suits, Skirts, and Coats	[illegible]
[illegible]	Women's, Misses', and Juniors' Outerwear, Not Elsewhere Classified	[illegible]
2341	Women's, Misses', Children's, and Infants' Underwear and Nightwear	[illegible]
2342	Brassieres, Girdles, and Allied Garments	750
2351	Millinery	[illegible]
2352	Hats and Caps, Except Millinery	[illegible]
2361	Girls', Children's, and Infants' Dresses, Blouses, Waists, and Shirts	[illegible]
[illegible]	Girls', Children's, and Infants' Coats and Suits	[illegible]
[illegible]	Girls', Children's, and Infants' Outerwear, Not Elsewhere Classified	[illegible]
2371	Fur Goods	[illegible]
2381	Dress and Work Gloves, Except Knit and All-Leather	[illegible]
[illegible]	Robes and Dressing Gowns	[illegible]
[illegible]	Raincoats and Other Waterproof Outer Garments	[illegible]
[illegible]	Leather and Sheep Lined Clothing	[illegible]
[illegible]	Apparel Belts	[illegible]
[illegible]	Apparel and Accessories, Not Elsewhere Classified	[illegible]
[illegible]	Curtains and Draperies	[illegible]
[illegible]	Housefurnishings, Except Curtains and Draperies	[illegible]
[illegible]	Textile Bags	[illegible]
[illegible]	Canvas and Related Products	[illegible]
[illegible]	Pleating, Decorative and Novelty Stitching, and Tucking for the Trade	[illegible]
[illegible]	Automotive Trimmings, Apparel Findings, and Related Products	[illegible]
[illegible]	Schiffli Machine Embroideries	[illegible]

Major Group 24—Lumber and Wood Products, Except Furniture

[illegible]	Fabricated Textile Products, Not Elsewhere Classified	[illegible]

Major Group 24—Lumber and Wood Products, Except Furniture

2411	Logging Camps and Logging Contractors	[illegible]
2421	Sawmills and Planing Mills, General	[illegible]
[illegible]	Hardwood Dimension and Flooring Mills	[illegible]
[illegible]	Special Product Sawmills, Not Elsewhere Classified	[illegible]
2431	Millwork	[illegible]
2434	Wood Kitchen Cabinets	[illegible]
[illegible]	Hardwood Veneer and Plywood	[illegible]
[illegible]	Softwood Veneer and Plywood	[illegible]
[illegible]	Structural Wood Members, Not Elsewhere Classified	[illegible]
2441	Nailed and Lock Corner Wood Boxes and Shook	[illegible]
[illegible]	Wood Pallets and Skids	[illegible]
[illegible]	Wood Containers, Not Elsewhere Classified	[illegible]
2451	Mobile Homes	[illegible]
2452	Prefabricated Wood Buildings and Components	[illegible]
2491	Wood Preserving	[illegible]
[illegible]	Particleboard	[illegible]
[illegible]	Wood Products, Not Elsewhere Classified	[illegible]

Major Group 25—Furniture and Fixtures

2511	Wood Household Furniture, Except Upholstered	[illegible]
2512	Wood Household Furniture, Upholstered	[illegible]
2514	Metal Household Furniture	[illegible]
2515	Mattresses and Bedsprings	[illegible]
2517	Wood Television, Radio, Phonograph, and Sewing Machine Cabinets	[illegible]
2519	Household Furniture, Not Elsewhere Classified	[illegible]
2521	Wood Office Furniture	[illegible]
2522	Metal Office Furniture	[illegible]
2531	Public Building and Related Furniture	[illegible]
2541	Wood Partitions, Shelving, Lockers, and Office and Store Fixtures	[illegible]
2542	Metal Partitions, Shelving, Lockers, and Office and Store Fixtures	[illegible]
2591	Drapery Hardware and Window Blinds and Shades	[illegible]
[illegible]	Furniture and Fixtures, Not Elsewhere Classified	[illegible]

Major Group 26—Paper and Allied Products

2611	Pulp Mills	[illegible]
2621	Paper Mills, Except Building Paper Mills	[illegible]
2631	Paperboard Mills	[illegible]
2641	Paper Coating and Glazing	[illegible]
[illegible]	Envelopes	[illegible]
2643	Bags, Except Textile Bags	[illegible]
[illegible]	Die-Cut Paper and Paperboard and Cardboard	750
[illegible]	Pressed and Molded Pulp Goods	[illegible]
2647	Sanitary Paper Products	[illegible]
[illegible]	Stationery, Tablets, and Related Products	[illegible]
[illegible]	Converted Paper and Paperboard Products, Not Elsewhere Classified	[illegible]
[illegible]	Folding Paperboard Boxes	[illegible]
[illegible]	Set-Up Paperboard Boxes	[illegible]
[illegible]	Corrugated and Solid Fiber Boxes	[illegible]
[illegible]	Sanitary Food Containers	[illegible]
[illegible]	Fiber Cans, Tubes, Drums, and Similar Products	[illegible]
[illegible]	Building Paper and Building Board Mills	[illegible]

Major Group 27—Printing, Publishing, and Allied Industries

2711	Newspapers: Publishing, Publishing and Printing	[illegible]
2721	Periodicals: Publishing, Publishing and Printing	[illegible]

Major Group 44—Water Transportation

3536	Hoists, Industrial Cranes, and Monorail Systems	2,500
3537	Industrial Trucks, Tractors, Trailers, and Stackers	2,500
3541	Machine Tools, Metal Cutting Types	750
3542	Machine Tools, Metal Forming Types	500
3544	Special Dies and Tools, Die Sets, Jigs and Fixtures, and Industrial Molds	100
3545	Machine Tool Accessories and Measuring Devices	500
3546	Power Driven Hand Tools	2,500
3547	Rolling Mill Machinery and Equipment	1,000
3549	Metalworking Machinery, Not Elsewhere Classified	500
3551	Food Products Machinery	500
3552	Textile Machinery	750
3553	Woodworking Machinery	500
3554	Paper Industries Machinery	500
3555	Printing Trades Machinery and Equipment	750
3559	Special Industry Machinery, Not Elsewhere Classified	500
3561	Pumps and Pumping Equipment	750
3562	Ball and Roller Bearings	2,500
3563	Air and Gas Compressors	2,500
3564	Blowers and Exhaust and Ventilation Fans	750
3565	Industrial Patterns	100
3566	Speed Changers, Industrial High Speed Drives, and Gears	2,500
3567	Industrial Process Furnaces and Ovens	100
3568	Mechanical Power Transmission Equipment, Not Elsewhere Classified	2,500
3569	General Industrial Machinery and Equipment, Not Elsewhere Classified	500
3572	Typewriters	2,500
3573	Electronic Computing Equipment	2,500
3574	Calculating and Accounting Machines, Except Electronic Computing Equipment	2,500
3576	Scales and Balances, Except Laboratory	1,000
3579	Office Machines, Not Elsewhere Classified	2,500
3581	Automatic Merchandising Machines	750
3582	Commercial Laundry, Dry Cleaning, and Pressing Machines	1,000
3585	Air Conditioning and Warm Air Heating Equipment and Commercial and Industrial Refrigeration Equipment	2,500
3586	Measuring and Dispensing Pumps	2,500
3589	Service Industry Machines, Not Elsewhere Classified	500
3592	Carburetors, Pistons, Piston Rings, and Valves	2,500
3599	Machinery, Except Electrical, Not Elsewhere Classified	100

Major Group 36—Electrical and Electronic Machinery, Equipment, and Supplies

3612	Power, Distribution, and Specialty Transformers	2,500
3613	Switchgear and Switchboard Apparatus	2,500
3621	Motors and Generators	2,500
3622	Industrial Controls	2,500
3623	Welding Apparatus, Electric	1,000
3624	Carbon and Graphite Products	2,500
3629	Electrical Industrial Apparatus, Not Elsewhere Classified	1,000
3631	Household Cooking Equipment	2,500
3632	Household Refrigerators and Home and Farm Freezers	2,500
3633	Household Laundry Equipment	2,500
3634	Electric Housewares and Fans	2,500
3635	Household Vacuum Cleaners	2,500
3636	Sewing Machines	1,000
3639	Household Appliances, Not Elsewhere Classified	2,500
3641	Electric Lamps	2,500
3643	Current-Carrying Wiring Devices	2,500
3644	Noncurrent-Carrying Wiring Devices	2,500
3645	Residential Electric Light Fixtures	500
3646	Commercial, Industrial, and Institutional Electric Lighting Fixtures	500
3647	Vehicular Lighting Equipment	2,500
3648	Lighting Equipment, Not Elsewhere Classified	2,500

Major Group 36—Electrical and Electronic Machinery, Equipment, and Supplies

3651	Radio and Television Receiving Sets, Except Communication Types	2,500
3652	Phonograph Records and Prerecorded Magnetic Tape	1,000
3661	Telephone and Telegraph Apparatus	2,500
3662	Radio and Television Transmitting, Signaling, and Detection Equipment and Apparatus	750
3671	Radio and Television Receiving Type Electron Tubes, Except Cathode Ray	2,500
3672	Cathode Ray Television Picture Tubes	2,500
3673	Transmitting, Industrial, and Special Purpose Electron Tubes	2,500
3674	Semiconductors and Related Devices	2,500
3675	Electronic Capacitors	2,500
3676	Resistors, for Electronic Applications	2,500
3677	Electronic Coils, Transformers and Other Inductors	500
3678	Connectors, for Electronic Applications	2,500
3679	Electronic Components, Not Elsewhere Classified	2,500
3691	Storage Batteries	2,500
3692	Primary Batteries, Dry and Wet	2,500
3693	Radiographic X-ray, Fluoroscopic X-ray, Therapeutic X-ray, and Other X-ray Apparatus and Tubes; Electromedical and Electrotherapeutic Apparatus	2,500
3694	Electrical Equipment for Internal Combustion Engines	2,500
3699	Electrical Machinery, Equipment, and Supplies, Not Elsewhere Classified	500

Major Group 37—Transportation Equipment

3711	Motor Vehicles and Passenger Car Bodies	2,500
3713	Truck and Bus Bodies	500
3714	Motor Vehicle Parts and Accessories	2,500
3715	Truck Trailers	2,500
3721	Aircraft	2,500
3724	Aircraft Engines and Engine Parts	2,500
3728	Aircraft Parts and Auxiliary Equipment, Not Elsewhere Classified	2,500
3731	Ship Building and Repairing	2,500
3732	Boat Building and Repairing	2,500
3743	Railroad Equipment	500
3751	Motorcycles, Bicycles, and Parts	2,500
3761	Guided Missiles and Space Vehicles	2,500
3764	Guided Missile and Space Vehicle Propulsion Units and Propulsion Unit Parts	2,500
3769	Guided Missile and Space Vehicle Parts and Auxiliary Equipment, Not Elsewhere Classified	2,500
3792	Travel Trailers and Campers	500
3795	Tanks and Tank Components	2,500
3799	Transportation Equipment, Not Elsewhere Classified	100

Major Group 38—Measuring, Analyzing, and Controlling Instruments; Photographic, Medical, and Optical Goods; Watches and Clocks

3811	Engineering, Laboratory, Scientific, and Research Instruments and Associated Equipment	750
3822	Automatic Controls for Regulating Residential and Commercial Environments and Appliances	2,500
3823	Industrial Instruments for Measurement, Display, and Control of Process Variables; and Related Products	2,500
3824	Totalizing Fluid Meters and Counting Devices	2,500
3825	Instruments for Measuring and Testing of Electricity and Electrical Signals	2,500
3829	Measuring and Controlling Devices, Not Elsewhere Classified	2,500
3832	Optical Instruments and Lenses	2,500
3841	Surgical and Medical Instruments	2,500
3842	Orthopedic, Prosthetic, and Surgical Appliances and Supplies	2,500
3843	Dental Equipment and Supplies	750
3851	Ophthalmic Goods	2,500

Major Group 38—Measuring, Analyzing, and Controlling Instruments; Photographic, Medical, and Optical Goods; Watches and Clocks

3861	Photographic Equipment and Supplies	2,500
3873	Watches, Clocks, Clockwork Operated Devices, and Parts	2,500

Major Group 39—Miscellaneous Manufacturing Industries

3911	Jewelry, Precious Metal	250
3914	Silverware, Plated Ware, and Stainless Steel Ware	2,500
3915	Jewelers' Findings and Materials, and Lapidary Work	100
3931	Musical Instruments	2,500
3942	Dolls	500
3944	Games, Toys, and Children's Vehicles; Except Dolls and Bicycles	2,500
3949	Sporting and Athletic Goods, Not Elsewhere Classified	750
3951	Pens, Mechanical Pencils, and Parts	750
3952	Lead Pencils, Crayons, and Artists' Materials	1,000
3953	Marking Devices	250
3955	Carbon Paper and Inked Ribbons	2,500
3961	Costume Jewelry and Costume Novelties, Except Precious Metal	100
3962	Feathers, Plumes, and Artificial Trees and Flowers	500
3963	Buttons	250
3964	Needles, Pins, Hooks and Eyes, and Similar Notions	1,000
3991	Brooms and Brushes	[illegible]
3993	Signs and Advertising Displays	100
3995	Burial Caskets	250
3996	Linoleum, Asphalted-Felt-Base, and Other Hard Surface Floor Coverings, Not Elsewhere Classified	2,500
3999	Manufacturing Industries, Not Elsewhere Classified	250

Div E — Transportation, Communications, Electric, Gas, and Sanitary Services

Major Group 40—Railroad Transportation

4011	Railroads, Line-haul Operating	1,500
4013	Switching and Terminal Establishments	500

Major Group 41—Local and Suburban Transit and Interurban Highway Passenger Transportation

4111	Local and Suburban Transit	100
4119	Local Passenger Transportation, Not Elsewhere Classified	50
4121	Taxicabs	50
4131	Intercity and Rural Highway Passenger Transportation	250
4141	Local Passenger Transportation Charter Service	50
4142	Passenger Transportation Charter Service, Except Local	50
4151	School Buses	50
4171	Terminal and Joint Terminal Maintenance Facilities for Motor Vehicle Passenger Transportation	50
4172	Maintenance and Service Facilities for Motor Vehicle Passenger Transportation	50

Major Group 42—Motor Freight Transportation and Warehousing

4212	Local Trucking Without Storage	100
4213	Trucking, Except Local	250
4214	Local Trucking With Storage	50
4221	Farm Product Warehousing and Storage	50
4222	Refrigerated Warehousing	25
4224	Household Goods Warehousing and Storage	25
4225	General Warehousing and Storage	100
4226	Special Warehousing and Storage, Not Elsewhere Classified	50

Major Group 59—Miscellaneous Retail

5962	Automatic Merchandising Machine Operators	100
5963	Direct Selling Establishments	50
5982	Fuel and Ice Dealers, Except Fuel Oil Dealers and Bottled Gas Dealers	15
5983	Fuel Oil Dealers	100
5984	Liquefied Petroleum Gas (Bottled Gas) Dealers	25
5992	Florists	25
5993	Cigar Stores and Stands	35
5994	News Dealers and Newsstands	50
5999	Miscellaneous Retail Stores, Not Elsewhere Classified	50

Div H — Finance, insurance, and real estate [8]

Major Group 65—Real Estate

6515	Operators of Residential Mobile Home Sites	100

Div I — Services

Major Group 70—Hotels, Rooming Houses, Camps, and Other Lodging Places

7011	Hotels, Motels, and Tourist Courts	100
7021	Rooming and Boarding Houses	25
7032	Sporting and Recreational Camps	15
7033	Trailering Parks and Camp Sites for Transients	15
7041	Organization Hotels and Lodging Houses, on Membership Basis	15

Major Group 72—Personal Services

7211	Power Laundries, Family and Commercial	50
7212	Garment Pressing, and Agents for Laundries and Dry Cleaners	15
7213	Linen Supply	100
7214	Diaper Service	15
7215	Coin-Operated Laundries and Dry Cleaning	15
7216	Dry Cleaning Plants, Except Rug Cleaning	15
7217	Carpet and Upholstery Cleaning	15
7218	Industrial Launderers	100
7219	Laundry and Garment Services, Not Elsewhere Classified	15
7221	Photographic Studios, Portrait	15
7231	Beauty Shops	15
7241	Barber Shops	15
7251	Shoe Repair Shops, Shoe Shine Parlors, and Hat Cleaning Shops	15
7261	Funeral Service and Crematories	15
7299	Miscellaneous Personal Services	25

Major Group 73—Business Services

7311	Advertising agencies	25
7312	Outdoor Advertising Services	25
7313	Radio, Television, and Publishers' Advertising Representatives	35
7319	Advertising, Not Elsewhere Classified	50
7321	Consumer Credit Reporting Agencies, Mercantile Reporting Agencies, and Adjustment and Collection Agencies	50
7331	Direct Mail Advertising Services	50
7332	Blueprinting and Photocopying Services	20
7333	Commercial Photography, Art, and Graphics	15
7339	Stenographic Services, and Reproduction Services, Not Elsewhere Classified	15
7341	Window Cleaning	15
7342	Disinfecting and Exterminating Services	50
7349	Cleaning and Maintenance Services to Dwellings and other Buildings, Not Elsewhere Classified [9]	50
7351	News Syndicates	400
7361	Employment Agencies	25
7362	Temporary Help Supply Services	250
7369	Personnel Supply Services, Not Elsewhere Classified [10]	250
7372	Computer Programming and Other Software Services	100
7374	Data Processing Services	100
7379	Computer Related Services, Not Elsewhere Classified	100
7391	Research and Development Laboratories [11]	100
7392	Management, Consulting, and Public Relations Services	25
7393	Detective Agencies and Protective services	100
7394	Equipment Rental and Leasing Services	15
7395	Photofinishing Laboratories	75
7396	Trading Stamp Services	500
7397	Commercial Testing Laboratories	50
7399	Business Services, Not Elsewhere Classified	25

Major Group 75—Automotive Repair, Services, and Garages

7512	Passenger Car Rental and Leasing, Without Drivers	25
7513	Truck Rental and Leasing, Without Drivers	50
7519	Utility Trailer and Recreational Vehicle Rental	15
7523	Parking Lots	20
7525	Parking Structures	25
7531	Top and Body Repair Shops	15
7534	Tire Retreading and Repair Shops	25
7535	Paint Shops	15
7538	General Automotive Repair Shops	15
7539	Automotive Repair Shops, Not Elsewhere Classified	15
7542	Car Washes	15
7549	Automotive Services, Except Repair and Car Washes	15

Major Group 76—Miscellaneous Repair Services

7622	Radio and Television Repair Shops	15
7623	Refrigeration and Air Conditioning Service and Repair Shops	15
7629	Electrical and Electronic Repair Shops, Not Elsewhere Classified	20
7631	Watch, Clock, and Jewelry Repair	15
7641	Reupholstery and Furniture Repair	15
7692	Welding Repair	15
7694	Armature Rewinding Shops	20
7699	Repair Shops and Related Services, Not Elsewhere Classified	15

Major Group 78—Motion Pictures

7813	Motion Picture Production, Except for Television	50
7814	Motion Picture and Tape Production for Television	50
7819	Services Allied to Motion Picture Production	6
7823	Motion Picture Film Exchanges	15
7824	Film or Tape Distribution for Television	20
7829	Services Allied to Motion Picture Distribution	30
7832	Motion Picture Theaters, Except Drive-In	60
7833	Drive-In Motion Picture Theaters	25

Major Group 79—Amusement and Recreation Services, Except Motion Pictures

7911	Dance Halls, Studios, and Schools	45
7922	Theatrical Producers (Except Motion Pictures) Bands, Orchestras, and Entertainers	35
7929	Bands, Orchestras, Actors, and Other Entertainers and Entertainment Groups	25
7932	Billiard and Pool Establishments	15
7933	Bowling Alleys	20
7941	Professional Sports Clubs and promoters	50
7993	Coin-operated Amusement Devices	25
7996	Amusement Parks	75
7999	Amusement and Recreation Services, Not Elsewhere Classified	25

Major Group 80—Health Services

8011	Offices of Physicians	25
8021	Offices of Dentists	15
8031	Offices of Osteopathic Physicians	15
8041	Offices of Chiropractors	15
8042	Offices of Optometrists	15
8049	Offices of Health Practitioners, Not Elsewhere Classified	15
8051	Skilled Nursing Care Facilities	200
8059	Nursing and Personal Care Facilities, Not Elsewhere Classified	200
8062	General Medical and Surgical Hospitals	500
8063	Psychiatric Hospitals	500
8069	Specialty Hospitals, Except Psychiatric	500
8071	Medical Laboratories	25
8072	Dental Laboratories	15
8081	Outpatient Care Facilities	100
8091	Health and Allied Services, Not Elsewhere Classified	100

Major Group 81—Legal Services

8111	Legal Services	15

Major Group 82—Educational Services

8299	Schools and Educational Services, Not Elsewhere Classified [12]	15

Major Group 89—Miscellaneous Services

8911	Engineering, Architectural, and Surveying Services [13]	60
8931	Accounting, Auditing, and Bookkeeping Services	25
8999	Services, Not Elsewhere Classified	25

Div A — Agriculture [14]

Major Group 01—Agricultural Production—Crops

0111-0191	Agricultural Production—Crops	[illegible]

Major Group 02—Agricultural Production—Livestock

0211	Beef Cattle Feedlots (Custom)	$1,000,000
0212-0291	Agricultural Production—Livestock, except 0211	[illegible]

[1] Except for Agriculture, all size standards are shown on an employment basis.

[2] SIC-1629: When bidding on dredging contracts, the firm must perform at least 40 percent of the yardage advertised in the plans and specifications, with dredging equipment owned by the bidder or obtained from another small business dredging concern.

[3] Division D, Manufacturing: "Rebuilding on a factory basis or equivalent." For rebuilding machinery or equipment on a factory basis, use SIC code applicable for new manufactured product.

[4] SIC-2911: For purposes of bidding on Government contracts, the firm does not have more than 30,000 barrels per day crude oil or bona fide feedstock capacity from owned or leased facilities or from facilities made available to such concern under an arrangement such as, but not limited to, an exchange agreement (except one on a refined-product-for-refined-product basis) or a throughput or other form of processing agreement, with the same effect as though such facilities had been leased, and the product to be delivered in the performance of the contract will contain at least 90 percent components refined by the bidder from either crude oil or bona fide feedstocks.

[5] SIC-4449: Includes offshore marine services.

[6] SIC-4521: Includes services requiring the use of one or more helicopters or fixed-wing aircraft.

[7] SIC-4899: Includes cable television service.

[8] Since most industries in Division H, Finance, Insurance, and Real Estate, are excluded from SBA assistance, only SIC-6515 is listed with a size standard.

[9] SIC-7349: Includes janitorial and custodial services.

[10] SIC-7369: Includes farm maintenance and food services.

[11] SIC-7391: For research and development contracts requiring the delivery of the manufactured product, the size standard to use is that of the manufacturing industry in which the specific product is classified.

[12] SIC-8299: Includes flight training services.

[13] SIC-8911: Includes naval architecture and marine engineering.

[14] Includes all SIC's in Major Groups 01 and 02, excluding [illegible]

of SIC's in Major Groups 07, Agricultural Services; 08, Forestry and 09, Fisheries.

**Due to the difficulty of identifying paid employees on the family farm, a dollar sales measurement is used as the size standard.

§ 121.3 Application of small business size standards.

The size standards definitions within this section apply to the following SBA programs: Financial Assistance, SBIC's, Surety Bonding, Pollution Control, Minority Small Business and Capital Ownership Development, etc., for the Procurement Assistance and Property Sales Programs, see § 121.4 and § 121.5, respectively. The following sections of the regulation are set forth in question-and-answer format for ease of application.

(a) *How do I determine if my firm is a small business eligible for SBA assistance?*

Since SBA size standards are set on an industry basis, you must first determine in which industry your firm is classified. To determine in which industry your firm is engaged, refer to the Standard Industrial Classification Manual.[1] Upon determining your firm's primary industry by the four-digit code, simply refer to the table contained in § 121.2 for the employment size standard.

(b) *What if my firm is engaged in a number of different industries?*

If an applicant for SBA assistance is engaged in a number of product lines or industries, or has affiliates engaged in different product lines or industries, the size standard shall be that of the firm and its affiliates' primary industry.[2]

(c) *Must I include employees in affiliated concerns?*

Yes. Employees of the firm applying for assistance, as well as all employees of firms affiliated with the applicant concern, must be included in the employee count. For an explanation of what would constitute an affiliate, refer to § 121.8.

(d) *How does SBA define employee?*

"Number of employees" means the average employment of any concern, including the employees of its domestic and foreign affiliates, based on the number of persons employed on a full-time, part-time, temporary, or other basis during each of the pay periods of the preceding 12 months.[3]

(e) *Am I an exception to the employee size standards?*

Maybe. There are three exceptions:

(1) A concern which applies for an SBA loan to refinance an existing SBA loan but which, since the date of the original financing has by natural growth as distinguished from merger, etc., grown to a size which exceeds the applicable size standard, is considered as small for the purpose of refinancing if SBA administratively determines that refinancing is necessary to protect the Government's financial interest.

(2) The applicable size standards for the purpose of all financial assistance programs of the Small Business Administration, except the Surety Bond Guarantee Assistance Program, are increased by 25 percent whenever the concern maintains or operates a plant, facility, or other business establishment within an area of substantial unemployment or underemployment or redevelopment area,[4] or is designated as a "Certified Eligible" concern by the Department of Labor and agrees to use the assistance within such area, or, if it does not maintain a plant, facility, or other business establishment within such area, agrees to utilize the assistance for the establishment and/or operation of a plant, facility, or other business establishment within such area.

(3) Financial assistance to farms. The size standard used to determine a small farm will be annual receipts[5] rather than number of employees.

(f) *At what time is the size status of the applicant firm and its affiliates determined for purposes of SBA financial assistance?*

The applicant firm's size status will be determined at the time of application for SBA financial assistance.

(g) *How do size standards apply to the 8(a) program within the minority small business and capital ownership development?*

At the time of entry to the MSB/COD program, your firm must meet the size standard for its primary industry as set forth in § 121.2.

§ 121.4 Definition of small business for SBA procurement assistance and subcontracting programs.

(a) *How do I know if my firm is a small business eligible to bid on Federal contracts set aside for small business?*

(1) For purposes of bidding on set-aside contracts, the applicable size standard will be the one for the industry that best depicts the product or service being procured. The firm's primary activity is not the controlling factor in determining small business eligibility for bidding on set-aside contracts.

(2) If your firm and all affiliates meet the corresponding size standard for that industry set forth in the solicitation by SIC code, then you are eligible to bid on the set-aside contract.

(b) *Who determines the appropriate SIC code for a set-aside procurement, and if there is a disagreement with the contracting officer's code selection?*

(1) The determination of the appropriate SIC classification of a product or service shall be made by the contracting officer of the agency letting the contract. Both the SIC classification and the applicable employee size standard shall be set forth in the solicitation, and the determination by the contracting officer is final unless appealed in the manner provided in § 121.9.

(2) An unclear or incomplete classification or size standard action by the contracting officer may be suplied by the SBA field office, or the Size Appeals Board or its Chairperson, as necessary, in connection with a size determination or size appeal.

(c) *What if the procurement calls for more than one item with different SIC codes and employment standards?*

If a procurement calls for more than one item, and the bidder can bid on any or all items, the bidder must meet the size standard for each item for which it submits a bid. If the procurement calls

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[1] The Standard Industrial Classification Manual is intended to cover the entire field of economic activities. It is the source used by SBA in defining industries for size standards. (You may obtain a copy of the publication from the Government Printing Office or in the reference section of most public libraries.)

[2] In determining which of the industries is the primary industry, consideration shall be given to these criteria, among others: distribution among such industries of receipts, employment, and costs of doing business.

[3] If a concern has acquired an affiliate during the applicable accounting period, it is necessary, in computing the applicant's number of employees, to include the affiliate's number of employees during the entire applicable accounting period rather than only its employees during the period in which it has been an affiliate. The employees of a former affiliate are not included even if such concern had been an affiliate during a portion of the applicable accounting period. If a concern has not been in existence for 12 months, "number of employees" means the average employment of such concern and its affiliates during the period that such concern has been in existence based on the number of persons employed during each of the pay periods of the period that such concern has been in business.

[4] "Redevelopment area," for the purpose of small business size determinations, means a geographical area within the United States which has been designated as a "redevelopment area" in accordance with the Public Works and Economic Development Act of 1965 (Pub. L. 89-136, Sec. 401, 79 Stat. 48).

[5] "Annual receipts" means the gross income (less returns and allowances, sales of fixed assets, and interaffiliate transactions) of a concern (and its domestic and foreign affiliates) from sales of products and services, interest, rents, fees, commissions, and/or from whatever other source derived, as entered on its regular books of account for its most recently completed fiscal year, whether on a cash, accrual, completed contracts, percentage of completion, or other acceptable accounting basis) and, in the case of a concern subject to U.S. Federal income taxation, reported or to be reported to the U.S. Treasury Department, Internal Revenue Service, for Federal income tax purposes.

for more than one item, and a bidder is required to bid on all items, the bidder can qualify as small business for such procurement if it meets the size standard for the item accounting for the greatest percentage of the total contract value.

(d) *Does my firm need to be certified by SBA prior to bidding on set-asides?*

(1) No. SBA provides a self-certification procedure where your firm certifies on the bid or proposal that it is a small business within the meaning of SBA Rules and Regulations.

(2) A firm which meets the size standard set forth in the solicitation and has not been determined ineligible as a result of a formal size determination, may represent that it is a small business. In the absence of a written protest or other information which would cause him to question the veracity of the self-certification, the contracting officer shall accept the self-certification at face value for the particular procurement involved.

(3) Firms self-certifying their small business status should be aware of the following provisions:

(i) If the contracting officer has cause to question the veracity of a self-certification and elects to do so, he shall refer the eligibility issue to SBA by filing a formal protest pursuant to § 121.8.

(ii) If a concern has been determined by SBA to be ineligible as a small business under a particular size standard and it has already self-certified as a small business on a pending procurement subject to the same or lower "number of employees" size standard, it shall immediately notify the contracting officer of such adverse size determination and shall not thereafter self-certify on a procurement subject to the same or a lower employee size standard until it has applied for recertification under § 121.7 based on a significant change in its ownership, management, or contractual relations, and has been determined eligible by SBA.

(e) *Does SBA distinguish between manufacturers and wholesalers for procurement purposes?*

Yes, there is a distinction. Any concern which submits a bid or offer in its own name, other than on a construction or service contract, but which proposes to furnish a product not manufactured by said bidder or offeror, is deemed to be a small business concern when:

(1) Its number of employees does not exceed the employment standard for the appropriate wholesale industry, and

(2) In the case of Government procurement reserved for small businesses, such wholesaler must furnish, in the performance of the contract, the products of a small business manufacturer [1] or producer whose products are manufactured or produced in the United States.

(f) *Are there exceptions to the provision regarding wholesalers?*

Yes. There are two exceptions to the wholesaling provision:

(1) If the procurement has anticipated value of less than $10,000 and is subject to, and is actually processed under, "small purchase procedures" as defined in the Federal Acquisition Regulation, or, pending issuance thereof by the Office of Federal Procurement Policy, in the Defense Acquisition Regulation (DAR), Federal Procurement Regulation (FPR), and the National Aeronautics and Space Administration Procurement Regulation (NASAPR), as applicable, such wholesaler may furnish any domestically produced or manufactured product.

(2) For the purpose of receiving a Certificate of Competency on an unrestricted procurement, a small business dealer meeting the size standard for its primary industry set forth in this section, may furnish any domestically produced or manufactured product.

§ 121.5 Definition of small business for the sale of government property.

The Property Sales Program is divided into three distinct areas: Timber, Mineral Rights, and General Property Sales, each with specific size standards and related requirements. While size standards for other SBA programs define eligibility by specific industry, the Property Sales Program focuses on potential bidders who represent a variety of industries. Consequently, for the Property Sales Program, size standards are aggregated into major industrial groups for each type of property sales.

(a) *How do I determine if my firm is a small business eligible on a preferential timber sale?*

In order to be classified as a small business, your firm must primarily engaged in the logging or forest products industry [6] and, together with your affiliates, have less than 500 employees. To determine your primary industry, see § 121.3(b).

(b) *Are there any other requirements that must be met when a small business wins a preferential timber sale?*

Yes. There are a few additional requirements and they are as follows:

(1) When the timber purchasee is for resale, the small business firm must agree that it will not sell [7] more than 30 percent of the timber purchased to large business firms (those exceeding 500 employees).

(2) When timber from a preferential sale is for processing, the small business must do so with its on facilities [8] or the facilities of another small business. § 121.5(b)(1) also applies to all processed timber.

(c) *How do I determine if my firm is a small business eligibe to bid on special salvage timber sales?*

Your firm would be a small business eligible to bid on Special Salvage Timber Sales if the firm is primarily engaged in the logging or forest products industry and, together with any affiliates, does not employ more than 25 employees during any pay period during the preceding 12 months.

(d) *Are there any other requirements?*

Yes. The provisions set forth in § 121.51(b) apply with one exception—special salvage timber may be disposed of without restriction when there are less than two qualified small business mills in the marketing area.

(e) *How do I determine if my firm is a small business eligible to bid on the sale of mineral rights?*

Your firm is a small business eligible to bid on the sale of mineral rights if your firm meets the employee size standard set forth below. When bidding on

(1) Coal leases—your firm, together with all affiliates, must have less than 250 employees;

(2) Uranium leases—your firm, together with all affiliates, must have less than 100 employees.

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[1] For size determination purposes, there can only be one manufacturer of the end item being procured. The manufacturer of the end item being procured is the concern which, with its own forces, transforms inorganic or organic substances including raw materials, and/or miscellaneous parts or components, into such end item. Whether a bidder on a particular procurement is the manufacturer or nonmanufacturer for the purpose of a size determination is not for determination by the contracting officer. The decision shall be made by the appropriate SBA regional director or his delegatee, and need not be considered with the contracting officer's decision as to whether such concern is or is not a manufacturer for the purpose of the Walsh-Healey Act, etc.

[6] "Forest products industry" means logging, wood preserving, and the manufacture of lumber and wood related products such as veneer, plywood, hardboard, particle board, or wood pulp, and of products of which lumber or wood related products are the principal raw material.

[7] The term "sell" includes but is not limited to the exchange of sawlogs for sawlogs on a product-for-product basis with or without monetary adjustment, and an indirect transfer such as the sale of the assets of (or controlling interest in) a concern after it has been awarded one or more set-aside sales of timber.

[8] This provision assumes that the successful bidder remain small business until the products have been manufactured. Requirements for disposal of timber from a preferential sale are set forth in § 121.5-1(b)(1).

(3) Royalty oil—your firm must have less than 2500 employees and not have more than a 30,000 barrels-per-day crude or bona fide stock capacity.

(f) *For the sale of any other type of government property, what is a small business?*

If your firm is primarily engaged in manufacturing and, together with all affiliates, employs less than 500 employees, it is eligible to bid on the sale of Government property. Firms engaged in industries other than manufacturing must have less than 50 employees.

Dated: February 28, 1980.

A. Vernon Weaver,

Administrator.

[FR Doc. 80-7111 Filed 3-7-80; 8:45 am]

BILLING CODE 8025-01-M

ATTACHMENT 2

CONTRACTOR REPORTS REQUIRED BY GOVERNMENT

	No. of Est. Pages	Comments
I. Securities and Exchange Commission		
1. Monthly Reports, Form 8K Report of certain unusual events of interest to investors Filed as required.	5 pages (9 copies)	Useful report
2. Quarterly Report, Form 10Q Financial results for quarter and related management analysis	12 pages (9 copies)	Useful, but ever increasing requirements make it overly difficult to comply.
3. Annual Report, Form 10K Complete description of business, financial statements, five year financial history, management analysis, and miscellaneous information.	35 pages (9 copies)	Useful, but ever increasing requirements make it overly difficult to comply.
II. Government Property		
1. Annual inventories of property to each agency from which Biospherics has received property.	1-2 pages (3 copies) to 3 different agencies.	Useful
2. Annual updates to Government Property Manual for all changes required by government regulations (Note: NASA sends 3 different auditors to annually audit property utilization, accountability & record keeping.	2-3 pages (1 copy)	Obviously drafted for large firms making extensive use of Govt. property - Nonsense for small firms.
III. Government Security		
1. Semi-Annual status reports	1 page (1 copy)	Useful
2. Updates of Biospherics' industrial security manual to comply with changes in Govt. regulations. (Note: The Industrial Security office conducts semi-annual ½ day audits of Biospherics' industrial security.	2-3 pages (1 copy)	Useless for us who have no classified information.

IV.	Defense Contract Audit Agency		
1.	Annual Report of costs. (see letter attached requires 40 hrs to prepare.)	10-12 pages 1 copy with addl. copies to EPA & NIH.	Basic idea is fine, but Agency is asking us to do its work!
V.	Contract Reporting		
1.	Monthly financial reports	1 page 3 copies for 8-10 contracts	Duplicates– in different format our invoices, unnecessary.
2.	Annual Patent reports	1 page 3 copies for 3-4 contracts	Useful.
VI.	Occupational Health & Safety Report		
1.	Annual Report to States of hours worked and accidents by category.	2 pages	What good this report does anyone is a mystery.
VII.	Group Insurance Reports		
1.	Annual reports to Dept. of Labor for health, life, disability & pension plans.	2 pages	Useless.
VIII.	Equal Employment Opportunity		
1.	Affirmitive Action Plan - updated annually & including extensive labor area & employment statistics (Est. 80 hours to prepare).	51 pages	A good idea run amuck!
2.	EEO-1- Annual statistical report on minority hiring (Est. 8 hours to prepare).	2 pages	Useful to ensure compliance.
3.	Veterans Admin. Report Report of number of veterans hired.	1 page	Useful to ensure compliance.

Note: There are conflicts in affirmative action about priorities among black, women, disadvantaged, veterans etc.

IX. <u>Small Business and Small Disadvantaged Business Subcontracting Plan</u>

1. Required in contracts with govt. of $500,000 or more (3-4-days to prepare) requiring the following info:	Est. 20 pages 4 copies	Ridiculous requirement.

a. Small & disadvantaged source lists.

b. Organizations contacted for small & disadvantaged sources.

c. Records supporting all subcontract solicitations over $10K.

d. Records to support other outreach efforts.

e. Records to support internal activities to guide and encourage employees (workshops, training programs etc.)

f. Records to support award data.

g. Total dollar planned subcontracting to small business, small disadvantaged business & large business.

h. A description of principal product & service areas to be subcontracted.

i. Method used in developing proposed subcontracting goals for small business & small disadvantaged business.

j. Method used in delivering the proprotionate share of indirect and overhead costs incurred with small business & small disadvantaged business.

TOTAL: 130 different reports per year, exclusive of all tax reports.

DEFENSE CONTRACT AUDIT AGENCY
PHILADELPHIA REGION
SILVER SPRING BRANCH OFFICE
8757 GEORGIA AVENUE, ROOM 1416
SILVER SPRING, MARYLAND 20910

IN REPLY REFER TO
6221A

17 January 1980

Biospherics, Inc.
4928 Wyaconda Road
Rockville, MD 20853

Gentlemen:

Your Government cost reimbursable contracts provide for reimbursement of indirect expenses such as manufacturing overhead, engineering overhead, general and administrative expenses.

The contract provides that a percentage of the fee be retained until the actual acceptable indirect rates have been determined.

By the terms of the contract you have ninety days after the completion of each fiscal year to make a submission disclosing your reimbursable direct costs and indirect rates.

We will review your submission, and when our review is completed, we will direct you to adjust all your vouchers to the agreed to direct costs and indirect rates. You will also be directed to submit your final voucher for each contract completed during the audited fiscal year.

In order to expedite the processing for final payment and closing of contracts completed, we are requesting you assistance in providing us with you submission(s) for the year(s) 12/31/79 ________ ________

________ ________ ________ ________ ________ ________.

If for any reason a submission can not or will not be made, please advise us of the circumstances.

The submission(s) as a minimum should consist of the following:

a. A schedule of your indirect expenses as recorded on your books of account, including any year-end adjustments, and exclusions for unallowable costs. A schedule for each pool of indirect expenses is required. The schedule should show your indirect expense distribution base and the development of the rate used to distribute the expenses.

b. A schedule showing you computations of allowable Independent Research and Development Expenses (DAR 15-205.35) and allowable Bid and Proposal Expenses (DAR 15-205.3).

c. A reconciliation of your total payroll to your total labor costs distributed to contracts and to other cost objectives.

16 January 1980

6221

d. A schedule of your cost reimbursable contracts showing the following:

(1) Contract Number
(2) Material costs for the period
(3) Labor costs for the period
(4) Other direct costs for the period
(5) Subcontract costs for the period, including copies of any required contracting officer approvals.

Contracts should be grouped in similar categories, i.e., cost plus fixed-fee (CPFF), cost plus incentive fee (CPIC), fixed price incentive fee (FPIF), time and materials (T&M), etc. Firm fixed-price (FFP) and commercial contracts may appear as a single line item for each category.

The totals from the above information should then be reconciled to the appropriate general ledger control accounts.

e. A reconciliatin of the costs billed for each contract to the incurred costs shown on your cost ledger for the period.

f. A schedule of your time and material contracts showing the following by task within each contract:

(1) Contract number/task order number
(2) Material costs and other costs billed for the period
(3) Labor hours by category for the period
(4) Billed labor costs using the fixed rates set forth in the contract
(5) Cost ceilings and cumulative amounts billed by task order

g. Copies of your financial statements and Federal and State income tax returns for the fiscal year referenced above. Should this data not be available at this time, please furnish as soon as possible.

Also, we would appreciate your advising us of any changes to your organizational structure, such as acquisition or divestiture of subsidiaries or changes in ownership, and any accounting system or procedure changes that may have occurred during the period.

When listing the contracts in (d) and (f) above, please note if they are CAS covered by placing an asterisk next to the contract number. To determine CAS applicability, you should refer to 4CFR331 (Title 4, Code of Federal Regulations Chapter 331) and the clauses contained in your contracts. If you qualify as a small business (DAR 1-701.1), contracts negotiated after 10 March 1978 may not be subject to CAS.

In the case of firm fixed-price contracts please supply a list of contract numbers since these contracts are not segregated by contract in d.

If you have CAS covered contracts, our review will include steps to determine if your accounting system is in compliance with CASB Rules, Regulations and Standards. We suggest that you become familiar with the standards, rules and regulations if you have not already done so, prior to the start of our audit.

STATEMENT OF

FRANK C. ROMANO, JR.

PRESIDENT AND TREASURER

AGAWAM ASSOCIATES, INCORPORATED
51 SUMMER STREET
ROWLEY, MASSACHUSETTS 01969
(617) 948-2717

AND

DIRECTOR

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

BEFORE THE

SENATE FINANCE COMMITTEE

ON

S.653, S.487, S.1481, S.2136,
S.2168, S.2152, S.2339

FRIDAY 28 MARCH 1980

Mr. Chairman and Members of the Committee:

It has been said that one of the most endangered species in our environment today is that of the small businessman, and I thank you for giving us the opportunity to express a voice in shaping a program of financial survival.

From America's earliest days to the present there has been one bedrock relationship which never has changed - the inseparable partnership between a free enterprise system that has become the world's greatest success story and small business.

The first permanent English settlement in America, Jamestown, was established in 1607 by small businessmen. And in 1776, when a new republic, or "commonwealth," was born, it was a system of government fitted to a spirit already developed: risk-taking, independent, innovative. The simple premise was that if Americans were left free to improve their lot, they would figure out how to do it.

Now we are on the threshhold of the decade of the 1980's - as a nation, an unparalleled success story whose economic foundation still rests on small businessmen who make up 97% of all American business.

Yet it is the alarming conviction of small business today that we have drifted far from the founding concept - far enough, in fact, to place small business and the private enterprise system itself in serious trouble.

Small business believes there is no more urgent call upon the attention of the leaders of government than this: the need for a revitalization of that private enterprise system. We must, small business contends, apply the same clarity of thought and purpose which created our system to a reexamination of much of the complexity we since have added.

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From the small business point of view, the top priorities in that reexamination must go to the following:

- o The need for increasing capital retention and capital formation.
- o Reducing and equalizing the burden of government paper work and regulation.
- o The creation of a higher-level relationship in government for small business that reflects its true economic importance.
- o The necessity to curb inflation and mitigate its impact.

Small business appreciates the concern for its future already shown by the House and Senate and by the administration through the creation of the White House Conference on Small Business.

Now it is time to translate that concern into actions which will revive and restore that risk-taking and innovative spirit - yet leave undisturbed that bedrock relationship between a government and its wealth-producing partner - that has made our nation what it is today.

Our nation already needs every ounce of ability small business has to produce wealth and jobs and to maintain its leadership role in innovation and that need won't slacken in the decade ahead.

But that demand has run head-on into a serious weakening of the primary ability every business must have - to generate and retain capital. Small business urges governmental leaders to adopt specific tax-reform proposals it believes are imperative to reverse that trend.

That acquisition and retention of capital is critical to the existence and growth of any business is self-evident. And the importance of a viable small business community should be equally evident.

Small business accounts for 43% of our Gross National Product (GNP) and for 53.3% of all business receipts. It produces more than half of all industrial inventions and innovations and 55% of all private-sector jobs. The fact is that of the 9.5 million new jobs created from 1969-76, small business accounted for 66%, or 6 million. An often-overlooked contribution of small business is the impetus it provides to the diversity of competition that benefits all consumers.

But there is one competitive arena in which small business and, indeed, all of business is finding itself pressed to the point of stagnation - the competition for capital. The supply simply is shrinking.

The result already is serious and could be devastating. From 1960-78, the United States was dead last in spending for new tools of production among major industrialized countries, for example, 13.41% of GNP vs. 26.44% for Japan. And in the same period our country was last also in the growth of private-sector output per hour, 2.6% per year growth vs. 8.8% for Japan.

Output per manhour is an accepted indicator of where we stand on productivity. And by that measurement, productivity is in dangerous decline. A major reason: capital investment, the key factor in productivity improvement, also shows an alarming drop. In the 1960-72 period, private sector capital spending grew at 4.9% per year and output per manhour at 2.9%, but in the 1972-78 period the comparable growth rates were 3.1% and 1.2%.

The council of Economic Advisers in its annual report stated the case bluntly:

"Only by devoting a significant share of current production to replace, modernize and expand the capital stock can we hope to maintain adequate growth in productivity."

There is no way small business or all business can meet that challenge as capital formation now stands. The single most important message business has for political leaders today is this, the shrinkage in internally-generated capital and outside risk capital is due directly to outdated tax laws that limit the former and inhibit the latter.

A revitalization for the 1980's must come through tax reforms which include modernization of tax laws governing depreciation of plant and equipment, a revision of restrictive capital gains tax provisions and a reshaping of the present corporate and individual income tax provisions.

Internally-generated funds - from retained earnings and capital cost recovery - are now in a double squeeze.

What is the situation in regard to recovery of invested capital? This source has been curtailed severely because present depreciation schedules for plant and equipment are based on "historical cost," a totally unrealistic approach which gives no recognition to the very real impact of inflation. If, for example, a small business spent $1,000 in 1968 to buy two identical machines, in 1978 the capital recovered from the original outlay would pay for the replacement of only one machine.

Today our nation, the innovator of 1776, has become the tail-ender in 1980 in capital cost recovery. The average capital cost recovery guideline life for all manufacturing in the U.S. is 12 years. In Canada, it's two years; in Great

Britain, one year, and in Western European countries, four to eight years. Moreover, Canada permits full capital cost recovery in 2.5 years and other industrialized nations have similar rapid recovery rates. In this land of free enterprise, it's 10 years. The question may well be asked: why don't we use rapid capital recovery as an economic tool to increase capital formation and productivity:

The present Asset Depreciation Range (ADR) regulations also carry other penalties: an unnecssary complexity that is particularly burdensome for small business and an overall unwieldiness that makes it difficult (to make the necessary quick response to technological change.

There are equally-damaging constraints on the other source of internally-generated funds - retained earnings. Small business finds it flatly impossible to give up as much as 46% of net income to taxes and continue to fill its role as creator of jobs and leader in innovation.

There are immediate and sensible remedies and small business urges their adoption:

S.653 - Capital gains roll-over

S.487 - Tax Credits - 10% on first $10,000 invested
5% on next $40,000 invested
a maximum $3,000 credit for individual
a $6,000 credit for joint

S.1481 - Small Business participating debentures

S.2136 - Graduated Income Tax

S.2167 - Increase Sub-Chapter S corporation participation from maximum of 15 to maximum of 100.

S.2152 - Used equipment investment credit to $200,000

S.2339 - Qualified stock options

In the capital formation area, lawmakers also must recognize the necessity in a small business revitalization for increased availability of external risk capital, particularly since the increasing expense of debt financing makes it an unrealistic alternative.

Venture capital more and more has been shunted into areas other than business under pressure of existing tax laws which penalize rather than encourage investment in small business.

Present capital gains tax law requires immediate payment of tax on the proceeds of the sale of a small business interest. That not only discourages investment - but promotes the sale of small businesses to large corporations through a tax-free stock exchange - a powerful force toward lessening of competition.

There is one other tax area of specific concern to small business: estate tax laws. As a matter of both capital formation and maintaining a broad competition, these should be revised to ease the tax burden on family-owned businesses and promote the continuity of family ownership.

I graduated from college in 1966 and joined IBM in sales where I was employed until 1972 except for a two-year military leave, serving in Vietnam.

During my employment at IBM, I received an invaluable education in the way a Fortune 500 company is managed. This experience had some carryover in developing my own small company.

My military service, which came approximately half-way in my 6 1/2 years with IBM, caused me to pause and contemplate what I wanted to do with my business career.

My father was an independent businessman and I developed through him an understanding of the many facets of business. However, despite this knowledge and the professional training I received at IBM, I really was not fully equipped to manage a small business. In 1973, during the first year it was offered, I enrolled in the Harvard Graduate School of Business Small Company Management Program and was graduated in 1975.

Through this program I had the opportunity to meet and live, for 3 1/2 weeks each year, with other small business men from the ages of 28 to 68 who had started and operated their own small companies. I found this personal interrelationship to be of great value to me when I first acquired my own company in 1974.

In order to continue and develop this relationship between small business men, in 1975 I joined the Smaller Business Association of New England and through their educational programs and the yearly Washington Presentation, I feel I am more equipped to address the problems facing me in my business.

THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC. is a private, non-profit, non-partisan association of 1,500 New England small companies. Founded in 1938 in conjunction with a national small business conference in Washington called by President Franklin D. Roosevelt, the Association is charged with promoting and protecting the welfare of small business throughout the six-state region. This is accomplished by:

(1) grouping together, articulating the needs of small business, and taking common action;

(2) promoting and supporting legislation and government activities beneficial to small business and opposing those activities and legislation detrimental to the interest of the smaller business;

(3) cooperating with other regional and national small business groups to increase Congressional, bureaucratic and public awareness of the small business sector; and

(4) educating small business executives in the operational and psychological aspects of a small enterprise, and enlightening small business men and women on matters which both threaten and preserve the system of free profit-incentive, private, competitive enterprise.

The major emphasis of SBANE's membership program is in the areas of of education and national legislation.

Besides appearances before Congressional committees and government agencies, the Association participates in the annual Washington Presentation, a meeting on Capital Hill of eight regional small business groups which propose specific recommendations to assist small business. The contemporary Presentation is an offshoot of a yearly gathering of SBANE members and New England Congressmen and Senators begun in the 1940's.

Embodying the above legislative objectives, the Association now has five members that sit on the national advisory boards or councils to the federal government, including persons on the U.S. Treasury Small Business Advisory Board and the U.S. Metric Council.

The education activities are many and varied. They include seminars and conferences held throughout New England, often sponsored in conjunction with leading New England universities and federal agencies such as the Small Business Adminstration.

SBANE's educational program includes a three-day live-in seminar, in the fall, at the Amos Tuck School at Dartmouth College and a series of one-day seminars called "50x50" featuring a variety of business subjects geared to the needs of small business, which are presented by an outstanding faculty drawn from throughout the country.

The Association publishes a monthly newsletter, SMALL BUSINESS NEWS, containing information and educational features for the small business executive.

Another publication, SBANE IN WASHINGTON, updates the membership about association activity in Washington and federal legislative and regulatory development germane to small business.

The Association's services also extended to counseling its members on small business problems and serving as a source of business information.

Furthermore, the Association provides government liaison, procurement assistance and offers its members group insurance programs and trade missions. SBANE maintains 15 standing committeees and/or individual experts in a spectrum of areas, from emerging topics as national health insurance to perpetual ones as taxation.

SBANE offices are located at 69 Hickory Drive, Waltham, Massachusetts, 02154, 617-890-9070.

CAPITAL FORMATION - AGAWAM ASSOCIATES

The company I purchased in 1974 had a sales volume of approximately $250,000 with 7 full and part-time employees. In 1980 our sales will exceed three million dollars and full and part-time employment has grown to 75 employees, and is continuing to grow at an annual increase of 33 1/3%.

We now have such prestigious clients as General Electric, Scudder Stevens and Clark, International Paper and Foster Parents Plan.

As I reflect back on how we have survived the initial years, it can be said that luck, persistence and a personal commitment that meant a seven day work week, played the greatest roll.

If I had to identify the one critical area during our early growth years, and if we are going to continue the growth rate established since 1974, it would-have to be unequivocally the area of Capital Formation.

When I acquired the company in 1974, I had approximately thirty thousand dollars accumulated through the stock option plan at IBM. I was able to acquire the company only because the founding owner, Irving Lippoldt, was in his late sixties and was experiencing certain changes in the business that required capital that he was unable to raise. The company was on the verge of going out of business.

Initially I joined the firm as an observer and immediately realized that if I was not able to obtain capital, I would be unable to purchase the firm. After several attempts at various savings and commercial banks, my loan requests were turned down. However, I did not lose faith. remembering the story of Tom Watson, Sr. being turned down for a $10,000 loan at several New York banks. However, a banker stated to nim that although he was still not impressed with Mr. Watson's financial presentation, but because of his persistence and tenacity and that what he lacked in financial strength would be made up by his personal persistence. Eventually, a bank president in the neighboring town of Ipswich agreed to loan me the $50,000 that I needed, but later reneged stating that there was too much of an age disparity between myself and the owner.

At this point it appeared that all was lost because the company had now built up a substantial trade debt and an outstanding withholding liability with the federal and state governments.

In a last effort, after meeting with the company creditors, I agreed to personally assume the company debts, which approximated $150,000 and give the founder a five-year employment contract to suffice as the purchase price.

As we proceeded to grow additional capital came begrudgingly and I was to find out that a turn-around situation takes a lot longer and more money than I had imagined or anticipated.

When we needed equipment, I traveled from leasing company to leasing company trying to sell the the turn-around and hoping they would overlook our financial situation and see the potential. I was forced to take any kind of financing I could obtain and at any rate.

I found so much of my time being consumed in raising capital that it became necessary to hire a general manager to handle the every day operation of the company. For me, raising funds had become a full-time job.

The next two sizeable amounts of money came from personal relationships with bankers. A local savings bank which had the original mortgage on the building, after listening to my story several times, committed to give us additional dollars to expand our physical plant. This loan became the largest single loan the bank had on its books.

The second source of funds came from a local commercial bank which had observed our survival of the initial three years. The bank gave us a $350,000 line of credit based upon the expectation that we would receive a guaranteed loan from the Farmers Home Administration, which we ultimately did in 1979. However, without the expectation of this loan, and without the personal commitment of its senior lending officer, Robert Sheeran, who was willing to look beyond normal credit criteria, I do not believe we would have obtained the original line of credit. Two-thirds of all the funds we have borrowed have gone into building and equipment, the balance has been used for working capital.

During this same period I had pursued Industrial Development Financing which would have allowed a reduced interest rate of one to four points below prime and a term of 20 to 30 years. It took well over a year to convince the small town of Rowley, population 3200, to adopt the enabling legislation of Industrial Development Bonds at the annual town meeting. The reason we had spent so much time pursuing this avenue of financing was purposely because of the advantages of term and interest rate. However, after a year of work we came to the realization that there was no market for bonds of Agawam Associates to add to its building and equipment. We were not a publicly traded company and had no rating, therefore, the only potential market for the bonds was our existing commercial bank which had already loaned us their legal lending limit. However, if the program that I presented to the White House Conference had been in effect at that time we would have been able to have had a 90% government guarantee attached to our Industrial Development Bond that would have allowed us to sell it in the open market. Futhermore, if the other bills now under consideration by your committee regarding capital formation had been passed, I would have been able to pursue other alternatives to capital formation.

Presented to

The White House Conference
on Small Business
Regional Caucus
Boston Sheraton Inn, Boxboro, Massachusetts
October 5, 1979

ALTERNATE PROPOSAL FOR CAPITAL FORMATION

Small businesses in general have been excluded from a very important source of capital formation, the Industrial Development Bond. The program has been in effect for several years, however, the average small business is unable to borrow money through this well-established program because of the unmarketability of a small company's bonds. The reason small business would be interested in using this program is that it would allow them to borrow anywhere between two to four points below prime. These kinds of funds are presently unavailable to small business through the SBA or the Farmers Home

Administration's B & I program. However, the Fortune 500 corporations have been using this program to build plants and buy new equipment very successfully and are able to borrow at this attractive low rate and longer terms. It would seem only fair and equitable that small businesses be given the same opportunity as their bigger brothers.

It is proposed that to make the industrial revenue bonds of a small business more marketable that an SBA guarantee and Farmers Home Administration guarantee be attached to the bonds, guaranteeing 90%. We have been advised by a major Wall Street investment firm (Salomon Brothers) that this guarantee, in fact, would make the bonds marketable and allow small business to avail itself to a program that has worked very well in the past to increase the flow of capital at a most attractive interest rate. It should also be noted that the SBA has implemented this program on a very small test basis in conjunction with EPA requirements that must be met by a small firm. At this point, although the program has had only a small amount of use, where it has been used, it has been successful.

This proposal is not a new and different approach that would require many months of evaluation, but would do nothing more than allow small business to take advantage of an established program that has proven itself over the years. Most important, it would enable small businesses to borrow capital at a rate between two to four points below prime which is presently unavailable to them except for some unique local government development programs.

CORPORATE FINANCE

Companies flock to tax-exempts

Early in September, Cincinnati Milacron Inc. sold $7.6 million worth of 25-year bonds and paid just 6.75%. Ordinarily those funds, which will finance a new industrial-robot plant in Greenwood, S. C., would have cost the company more than 10%. But Cincinnati Milacron cut its interest expense by selling tax-exempt industrial development bonds (IDBs) through a government agency.

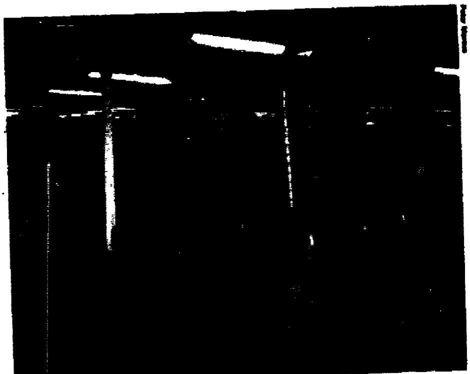
The use of tax-exempt financing by companies for expansion programs (excluding pollution control) has virtually exploded in recent months, largely because of a change in the federal tax law that doubled the limit on IDB financings to $10 million per project. Meanwhile, states have liberalized their own regulations and have been pushing aggressively this low-cost financing as an inducement to businesses to locate in the state and boost employment and the local economy.

The rapid rise in interest rates plus hot investor interest have added to the allure of tax-free bonds by widening the gap between their interest cost and that of taxable bonds to as much as 3.5%. Tax-exempts usually cost 2 to 2.5 percentage points less.

Pace of new issues. Companies issued $930.2 million worth of IDBs from January through July—a 94.7% jump from the level in the corresponding 1978 period, according to the Public Securities Assn. These low-cost funds are being used to finance everything from Merillat Industries Inc.'s cabinetmaking plant in Lakeville, Minn., and a Wang Laboratories Inc. office building in Lawrence, Mass., to Club Med Inc.'s new ski resort in Colorado, plus scores of McDonald's Corp. franchises in Pennsylvania.

Meanwhile, the pace of new issues for pollution control, a special and unrestricted type of IDB, has slowed. More than $2 billion worth of these bonds, which are most often issued by steel, paper, chemical, and utility companies, were sold in each of the last two years. But the volume of new issues so far this year has fallen 40% below 1978's pace.

Still, the torrid pace of issuing IDBs used strictly for economic development has attracted unwanted attention and some criticism. By allowing this back-door form of subsidy, Congress intends primarily to aid small business. But critics of IDBs contend that, instead, big and well-heeled companies are getting away with liberal use of such financing breaks. Further, some critics gripe that although IDB-financed industrial operations may increase jobs as well as revenues from payroll and sales taxes, fast-food outlets add little and should not be funded with taxpayers' dollars.



Merillat used industrial development bonds for this Minnesota plant.

Technically, IDBs are issued by a municipality, county, state, or a state development agency on behalf of a corporation. But although the government entity's name is on the bonds, it is the company's credit and financial wherewithal that are on the line. The company is responsible for paying off the bondholders, although occasionally there are slipups, as with the bonds of a 1.3 million-sq.-ft. warehouse built by Allied Supermarkets Inc., now in Chapter XI bankruptcy. Allied sold $33 million worth of tax-exempt bonds in 1967 through the city of Livonia, Mich., to finance the warehouse's construction. While the city retained legal title to the warehouse, it assumed no obligation for the bond payments, and the bond indenture did not spell out Allied's obligation to the bondholders. When Allied filed for bankruptcy, the bondholders were left in the lurch. They may yet recover some of their investment if a recent proposal to sell the warehouse goes through.

Loose interpretations. Industrial development bonds are used primarily to finance a specific, new industrial plant or manufacturing facility. A company is not permitted to use IDBs as part of a general capital-raising effort, nor is it allowed to finance an existing plant retroactively through IDBs.

But those restrictions are interpreted loosely. For example, plenty of states will permit a company to use IDBs to build a new wing or add new equipment to an old plant, provided the overall capital expenditures on the plant do not exceed $10 million for the three years before and after the tax-exempt financing. Pennsylvania permits such commercial outfits as a Burger King Corp. or McDonald's franchise to qualify for tax-exempt financing as long as it "creates or preserves" 20 jobs and has a total value of at least $200,000, according to Shirley J. Dunaway, administrator of tax-exempt financing for the Pennsylvania Commerce Dept. Qualifications for industrial plants are lower: five jobs and a minimum cost of $100,000.

Not surprisingly, all the new tax-exempt bonds shake up some people. "We're always concerned about any increase in their use," says one tax specialist with the Treasury Dept., which begrudges any loss of tax revenues. It was just this sort of popularity that led the Treasury to crack down on the issuance of IDBs in 1969. In the prior two years, annual sales of IDBs rose to about $1.5 billion, and large companies often issued them. In 1969, Treasury set a $5 million limit on how much could be raised for any one expansion project, although no limit was set on the sale of pollution control bonds. The volume of IDBs unrelated to pollu-

FINANCE

tion dropped to about $400 million a year. Finally, moans from supporters of small business about the burden of high interest rates and the effects of inflation on project size moved Congress to force a reluctant Treasury to raise the ceiling to $10 million, effective in January this year. Although the Treasury chafes at the increased use of IDBs, it is wary of pushing to curtail them after the setback it suffered last year in Congress.

General aid. One of the IDB's most vocal critics is Ralph Nader, whose organization published a report last month attacking all forms of tax-exempt financing. The report asserts that IDBs will cost the Treasury $10 billion over the next 10 years in lost revenues, based on the amount currently outstanding.

Growth in the use of IDBs has been a bonanza for Wall Street investment banking firms, which are hard-pressed for business and are grabbing for every piece of new action they can get. Virgil B. Pettigrew, chief financial officer of Dallas-based E-Systems Inc., claims that he has been approached during the last year by six to eight investment bankers hoping to do a tax-exempt deal. "They see an announcement about expansion programs and want to cash in," says Pettigrew. "They have been pretty aggressive."

There has also been a lot of investor demand for such issues. Banks and property and casualty insurance companies have traditionally been big buyers. Now, individuals whose salaries have been pushed into high tax brackets by inflation have been active as well.

Meanwhile, there is little to discourage a qualified company from issuing tax-exempt bonds except the selling costs, which tend to be higher than those on taxable bonds. Kevin J. Collins, a managing director of First Boston Corp., notes that a company pays underwriting and selling fees of about $14 to $17.50 per $1,000 bond, vs. $8.75 on a taxable bond, largely, he says, because a tax-exempt issue is harder to sell. In addition, the company runs up big legal bills while arranging a deal and getting necessary approvals. One way to shave costs is to package several deals, as Ex-Cell-O Corp., of Troy, Mich., is doing. Ex-Cell-O has lumped together four separate financings worth a total of $20 million and plans to sell them in the spring. The packaging will save the company $40,000 in underwriting fees. Each of the issues will be sold simultaneously through government entities in the states where Ex-Cell-O will build or expand its plants: New Hampshire, New Mexico, Florida, and Iowa.

This preparation may be a headache. But, says Stanley T. Pardo, executive vice-president of Blyth Eastman Dillon & Co., "In a high-cost environment, companies are becoming more aware of the low-cost options and are taking the time and trouble to put that kind of financing together." ■

Industrial revenue bonds

Perhaps one of the most overlooked methods of raising capital is the industrial revenue bond, a by-product of congressional attempts to help the states lure new business.

Richard L. Leavitt used this method to raise $200,000. Mr. Leavitt, president and owner of the 83-year-old Chelsea Clock Co., Inc., Chelsea, Mass., needed new machinery and 1,800 additional square feet to continue the firm's current level of operations.

"But as a business manager I could not justify the addition by means of conventional financing. It is just too expensive, and over 25 years the interest rates will kill you."

Through the assistance of the Massachusetts Industrial Finance Agency, which helps businesses issue industrial revenue bonds, Mr. Leavitt obtained $200,000 at nine percent interest over 20 years. Most of the investors were bankers or insurance companies.

"I could have overlooked this method of financing and would now be sitting on a 20-year, $200,000 loan repayable at 15 percent. The bond method took a little longer [three months] than traditional means, and it meant filling out a lot of forms, but once that was done, I saved a lot."

The appeal of industrial revenue bonds is that they are tax exempt. Congress recently almost doubled the limit on bond financing to $10 million, and many states interpret the limitations loosely to encourage firms to relocate.

A new angle for increasing the use of these bonds was proposed at the White House Conference on Small Business. The proposal to establish an SBA guaranteed bond has been pushed for months by Frank C. Romano, Jr., president of Agawam Associates, Rowley, Mass. With the help of a Wall Street investment banking firm, Mr. Romano packaged the proposal for the conference.

"Small business has been excluded from a very important source of capital . . . because of the unmarketability of small companies' bonds," he says. To make small firms' bonds more viable, he is asking SBA and the Farmers Home Administration for a 90 percent guarantee. "This would permit small firms to borrow capital at a rate two to four points below the prime," says Mr. Romano.

Opposition at Treasury

While SBA has a pilot program to help manufacturers of pollution control equipment finance their businesses through bonds, chances of support for a broad-based guarantee program are doubtful.

"The Treasury Department has always been against the use of tax-free bonds as a means of generating capital," says SBA Administrator Weaver. "And it is my suspicion that any company that has a credit rating to secure bond revenue can get the money elsewhere."

In a letter to Mr. Romano, Harry K. Schwartz of the White House domestic policy staff reiterated Mr. Weaver's contentions.

"I anticipate resistance to the proposal from OMB [Office of Management and Budget] and the Treasury," says the letter, "but I find it quite appealing and intend to pursue it."

Meanwhile, critics of revenue bonds estimate that their use will cost the Treasury $10 billion in revenue losses over the next ten years.

"In times when dining at the money market table leaves a small business owner starving," says Mr. Romano, "any means of generating new sources of capital should be regarded as a positive step for the overall economic well-being of the country."

NATION'S BUSINESS • FEBRUARY 1980

Testimony by

Thomas J. Perkins, General Partner

Kleiner, Perkins, Caufield & Byers

March 28, 1980

SUBCOMMITTEE ON TAXATION

AND DEBT MANAGEMENT

<u>SUMMARY</u>

TESTIMONY ON BEHALF OF THE NATIONAL VENTURE CAPITAL ASSOCIATION
In Favor of S.2239 (Incentive Options)

1. Incentive options are a vital tool for venture capitalists.
2. Attractive options were eliminated by the Tax Reform Act of 1976.
3. Lack of the option tool causes new ventures to have higher salaries than previously, and is thus very inflationary.
4. A return to the stock option plans as they existed in 1964 would have a positive revenue impact as verified by the Congressional Joint Committee on Taxation.

It is a pleasure to testify before the Subcommittee on Taxation and Debt Management on behalf of the National Venture Capital Association. My comments are directed primarily to S.2239 (incentive options) but I will also comment on S.487 (tax credits), S.653 (roll-over), S.2136 (reduced corporate tax rates), S.2152 (used machinery investment tax credit) and S.2168 (subchapter S corporations).

I am a practicing venture capitalist active in high technology enterprises in Northern California. I got my start as an inventor of one of the kinds of laser; subsequently I have been involved in computers and more recently in molecular biology and recombinant DNA. My partners and I are active investors in some 20 companies. The National Venture Capital Association consists of about 80 member firms which are similarly involved in new venture formation and the development of high-growth innovative industries throughout the United States.

Our Association has had the restoration of incentive options as one of its highest priorities for several years. The tax changes of 1976 eliminated options as one of our most essential tools for the building of new innovative companies. Typically, the businesses we finance, while burgeoning with potential, involve considerable risk. In order to attract technical and managerial talent from the larger and more secure corporations, we need to offer significant incentives. Our experience in offering "non-qualified options", which are all that are available under the present tax law, has been quite bad.

The present law taxes the difference between option exercise price and market value as income and requires that regular income tax be paid at the time of exercise. This frequently forces the individual to sell the stock to raise cash to pay the tax, and thereby lose the further incentive which the option was intended to provide in the first place. Much worse, if the subsequent market value declines below the option exercise price, the tax on the initial paper profit income is due anyway. Three of the top managers in the laser company of which I am a Director got caught in this situation and each had to pay between $50 and $80 thousand dollars in taxes, when in fact they had absolutely no profit whatsoever. Ironically, under the present law the corporation took a deduction about equal to the taxes they paid so the net revenue to the Federal Treasury was zero.

Horror stories like these are common and have given "non-qualified options" a very bad reputation. I know of few venture capitalists who any longer attempt to use them. Instead we have to pay salaries competitive with, or usually at, a premium over those offered by the less risky larger firms. This has obviously had an inflationary effect on the cost of getting a new venture started and, while the reduction in capital gains tax rate in November 1978 has been a tremendous stimulus to the industry, we are creating fewer companies and jobs per dollar than in the past because of this inflationary effect.

We therefore urge favorable consideration of S.2239 which would return the stock options to essentially the status which existed in 1964. The key ingredient we need, of course, is treatment of profit on the option as a capital gain at the time the stock is sold. This treatment will eliminate the "Russian roulette" aspect entirely from the present tax treatment which forces an individual to exercise early, and often times too early.

Importantly, S.2239 will have a positive revenue impact as determined by the Congressional Joint Committee on Taxation. This is because the corporation will lose the present deductibility of the income portion of the stock profit. Yet shareholders of smaller high-growth corporations favor the proposed change vs. the present situation since fewer total shares are required to provide a meaningful incentive and hence dilution is minimized.

Prior to 1964 when the marginal tax rate on earned income was 90% and the maximum rate on long-term capital gains (requiring only 6 month's holding) was 20%, pressure existed to provide compensation in the form of options, and a few documented abuses arose. Now with the marginal income rate at 50% and the capital gains rate at 28% and with the proposed 2-year holding period after exercise in effect, the pressure for abuse will be enormously minimized. Also, current SEC requirements require shareholder approval for option plans for publicly-owned businesses, thereby further eliminating any potential for adverse application of option plans.

Our organization believes that the advantages in restoring the stock option as an incentive tool overwhelmingly outweigh any risks. As with the reduction of capital gains taxes, we believe that the economy will witness a further increase in the pace of the formation and growth of the kinds of new innovative businesses which our nation so badly needs, with the return of meaningful option incentives.

Our organization is generally in favor of S.487, S.653, S.2136, S.2152 and S.2168. We typically invest to create long-term value and ultimate capital gains and, very rarely, for short-term income or tax shelter purposes. Thus, S.653, which provides for nonrecognition of gain if reinvestment is made within 18 months in another incentive stock, is totally consistent with our goals and would be very attractive.

S.2136 and S.2152 are attractive in that they provide direct tax benefits to the businesses we finance and thereby give our venture dollars greater leverage. We are in favor of both Bills.

The expansion of Subchapter S corporations from 15 to 35 shareholders as provided by S.2168 is quite desirable by many of our members, particularly those who invest from family resources rather than from corporate capital pools. It is important that this segment of our industry remain healthy.

And lastly, S.487 which provides for an investment credit of up to $3,000 per individual, while not directly of importance to our member firms is indirectly very important to us since this incentive should strengthen the markets materially for new issues of stock of the corporations we have backed.

Thank you for your attention to these comments.

[Thereupon, at 11:40 a.m. the committee recessed to reconvene at the call of the Chair.]

VARIOUS TAX PROPOSALS

TUESDAY, APRIL 1, 1980

U.S. SENATE,
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT GENERALLY,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 9 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd, Nelson, Baucus, and Chafee.

Senator BYRD. The hour of 9 a.m. having arrived, the committee will come to order.

The hearings today will focus on proposals to encourage investment and capital formation in the small business sector. The proposals stem from the White House Conference on Small Business and the work of the Senate Task Force on Small Business, of which Senator Gaylord Nelson of Wisconsin is chairman.

At this point, I want to commend Senator Nelson for his great activity in this matter.

The proposals stem from the agenda prepared by the White House Conference on Small Business. At that conference were some 1,700 businessmen and women from throughout our Nation.

It is important to note that the top four recommendations of the White House Conference on Small Business deal with taxes and Government spending. While the White House Conference gave priority to tax measures, it also placed high on its agenda balancing the Federal budget and limiting Federal spending as a percentage of gross national product.

The Small Business White House Conference perceives very clearly the relationship between high taxes, high Government spending, and the effect of Government deficit spending upon the economy.

The effect upon small businesses of inflation generated by Federal Government spending is devastating. Long-range planning for expansion and the development of new products is an inflationary environment is impossible.

Small businessmen must live with uncertainty on a daily basis as the cost of labor and supplies fluctuate upward.

Capital needed for expansion generated either internally or through outside sources dries up or becomes prohibitively costly as interest rates soar. Businessmen must watch helplessly as the economy follows a boom-and-bust roller coaster ride.

The proposals of the Small Business White House Conference must be viewed in a context of Federal spending reductions, yet this Senator, for one, is not encouraged by events of yesterday. First, the Senate Budget Committee, by a very close vote, a one-vote margin, approved a third concurrent budget resolution increasing by $18 billion the spending for fiscal year 1980, our current fiscal year.

That was only 4½ months ago, on November 16, that spending was put by the Senate at $548 billion. The Budget Committee, by a one-vote margin yesterday, voted to raise that spending for 1980 to $566 billion.

That is not at all encouraging.

Yesterday also the President submitted his third budget proposals within 63 days. The news media—or perhaps I should say most of the news media—quoted the President that he had made a $15 billion reduction in his budget proposals and such is not the case at all.

In fact, the President's proposal yesterday, if enacted into law, would increase Government spending by $64 billion.

Capital formation for small business is an important element in a program of spending cuts and tax reductions. The agenda of the Small Business Task Force is very impressive.

As part of the record, I am placing in the hearing a summary of the top 15 proposals of the White House Conference on Small Business. I will place that in the record at this point.

[The material referred to follows:]

THE TOP 15

Below is a summary of the 15 issue options which received the most votes from the delegates:

1. Graduate the corporate and individual income tax schedules; set the corporate surtax threshold at $500,000.

2. Simplify and accelerate the capital cost recovery system.

3. Balance the federal budget by statute in Fiscal Year 1981 by limiting total federal spending to a percentage of the GNP, commencing with 20 percent and declining to 15 percent.

4. Lower estate taxes for family-owned businesses.

5. Institute sunset reviews of all laws, regulations, and agencies, to ensure that none exceeds original congressional intent. Cost benefit analyses of the impact of each regulation and agency should be undertaken by a Regulatory Review Board composed of representatives from the Executive Branch, Congress and small business owners. Congress may line-item veto regulations, with only a one-house floor vote.

6. Support and urge passage of the Small Business Innovation Act, which proposes revisions in the tax, patent, regulatory and procurement codes to foster greater small business innovation and subsequent commercialization.

7. Provide for a tax credit for initial investment in a small business, and permit deferral of taxes for roll-overs of investments affecting small business.

8. Move the Social Security System toward actuarial soundness by: 1) including all constitutionally eligible public and private sector employees as contributors; 2) limiting benefits to the original old-age and survivor benefits; 3) freezing the tax base and rate at the January, 1980 level; and 4) eliminating double dipping.

9. Create a new security called a Small Business Participating Debenture to provide another source of capital for small businesses.

10. Pressure the independence of the Office of Advocacy, making its mission the top priority at the Small Business Administration (SBA), by ensuring its budget to be not less than 5 percent of the SBA salary and expense budget.

11. Private lending institutions should be required to provide equal access to commercial credit for women in business.

12. Small businesses who win civil disputes with the federal government should be reimbursed for court costs, reasonable attorney's fees, and damages from administrative action.

13. Freeze minimum wage standards at January, 1980 levels, and establish a two-tier minimum wage by exempting teenagers, seasonal workers and part-time workers.

14. Mandatory procurement goals should be set for federal contracts to reach the following percentages (on a contract-by-contract or agency-wide basis): 35 percent—small businesses; minority-owned businesses—15 percent; and women in business—10 percent.

15. Similar to number 5, excluding the line-item Congressional veto and the Regulatory Review Board.

By subject area, this is where the top 15 votegetters fall: Capital formation, 5; Women in Business, 1; Minority Business Development, 1; Government Regulations and Paperwork, 2; Innovation and Technology, 1; Economic Policy and Government Programs, 2; Inflation,3.

Senator BYRD. The committee is pleased today to have a number of important and knowledgeable witnesses. The first panel will be a panel of attorneys, the second a panel of small businessmen, and the third a panel of small business organizations.

For the first panel of attorneys, on that panel will be Mr. Frederick G. Corneel of Boston, Mass.; Mr. Converse Murdock of Wilmington, Del.; and Mr. Charles M. Walker, president, ABA tax section.

Will you gentlemen come forward?

The committee is pleased to have you and you may proceed as you wish.

Mr. Corneel?

Mr. CORNEEL. Mr. Walker will speak first.

Senator BYRD. Welcome, Mr. Walker.

Mr. WALKER. Thank you, Mr. Chairman.

Senator BYRD. I am glad to see you back before this committee. You used to appear here frequently when you were with the Treasury Department.

Mr. WALKER. Well, it is a pleasure to be back here in this role as well, Mr. Chairman, it really is, and I thank you for giving us an opportunity to speak.

STATEMENT OF CHARLES M. WALKER, ESQ., CHAIRMAN, TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. WALKER. As you have indicated, I am appearing here this morning as the chairman of the section of taxation of the American Bar Association and, as such, I am pleased to express the views of the American Bar Association and of the tax section on the tax proposals which would encourage small businesss.

Neither the association nor the tax section, however, has adopted a position on subjects covered by any of the bills that are identified in the announcement of these hearings, except for S. 2168.

I will, therefore, comment only on that bill and in addition, I will respond to the invitation of the committee to comment on other tax matters which, I think, are of interest to the small business community.

Tax policy adopted by the American Bar Association has addressed these issues in two different ways. One is by recommendation of specific changes in the tax law. The other is by recommendation that a program be established to simplify the Internal Revenue laws.

I have attached as an appendix to my written statement, Mr. Chairman, the text of that simplification proposal.

Now, over the years, the section on taxation has recommended, and the house of delegates of the association which is the association's policymaking body, has adopted a large number of recommendations to change the tax laws for the various reasons set forth in the reports which accompanied those recommendations.

Several of those recommendations, if adopted, would be of substantial aid to the small business community. Among the proposals is a recommendation which has the same objective as does S. 2168.

It recommends that the number of shareholders in a subchapter S corporation should be increased to 30 under the ABA proposal. S. 2168 provides for an increase to 100 stockholders.

That is certainly a move in the same direction, though it goes a bit further than does the ABA.

The present limitation of 15 shareholders interferes with flexibility in financial planning and business management, quite unduly restricting the corporation's ability to raise capital or to award stock to key employees.

The limitation also prevents many businesses from benefiting from the subchapter S purpose of achieving the nontax objectives of incorporation without incurring a corporate tax.

The development of automated efforts of correlating information on the returns of such corporations with the returns of their shareholders on audit has made unnecessary the administrative convenience of keeping such close limits on the number of shareholders.

Neither the tax section nor the association, however, has considered the portion of S. 2168 which deals with the ability of a subchapter S corporation to issue an additional class of stock. Accordingly, I will not comment on that aspect of the bill.

The subject of subchapter S corporations clearly is of interest to the small business community. The whole area needs reexamination in depth so that rules can be simplified and made more easily usable by small businesses.

Indeed, a reexamination of the subchapter S rules has been underway for some time by the staff of the Joint Committee on Taxation. The section of taxation's committee on subchapter S corporations has been working with the staff, and with Treasury representatives, in evolving a revision of these rules, and that revision is long overdue.

I hope that it can be raised to a suitably high priority to enable definitive action in the near future. Meanwhile, over the years, there have been several legislative recommendations affecting the subchapter S provisions which have been proposed by the tax section and approved by the house of delegates.

These are summarized in an exhibit attached to our written statement.

Briefly, in addition to providing for an increase in the maximum number of permitted shareholders, as is contemplated by S. 2168, they are designed to do the following.

First, to permit a subchapter S corporation to own stock in an inactive subsidiary.

Second, to permit an estate in bankruptcy to be a shareholder of a subchapter S corporation.

Third, to eliminate the requirement that a subchapter S corporation have no more than 20 percent of its gross income from passive investment income.

Fourth, to correct certain technical defects in the definition of a subchapter status.

Fifth, to modify the rules relating to distributions by subchapter S corporations.

Clearly, when approaching legislation in the subchapter S area, it would be highly desirable to do more than handle only one or two isolated problems. The ABA recommendations have evolved over the last 5 years and represent the current position of the association and precise statutory language to achieve these objectives has been proposed for each of them and is available to the staff if that is desired.

So certainly an early revision of subchapter S in which these recommendations would be considered certainly should occur, but if it does appear unlikely to occur, it is highly desirable to move forward at least with these specific recommendations that are in the book.

Another area of tax law which is of interest to the small business community relates to the redemption of stock of closely-held corporations. In that respect, there are three recommendations comprising association policy, all of which we recommend to the committee for attention.

Attached again to my written statement is my summary of these and I will mention them briefly here.

One of the recommendations provides that a redemption of stock which qualified as a complete termination of interest, thus insuring the redemption proceeds against treatment as an ordinary dividend, should not lose such status merely because the shareholder reacquires stock in the corporation during the following 10-year period through enforcement of his rights as a creditor.

Another recommendation relating to redemption extends the period within which an agreement must be filed notifying the Internal Revenue Service of a reacquisition of stock after a redemption which does qualify as a complete termination of interest.

Present law requires that such an agreement be attached to a timely filed return for the year of the distribution.

The recommendation is to permit the filing of the agreement with the first return filed for that year, whether or not timely, or whenever reasonable cause for failing to file the agreement with the return can be established.

The third recommendation in the stock redemption area adds the basis of the stock redeemed to the basis of other stock owned by the shareholder in cases where the distribution proceeds are treated as a dividend received, instead of proceeds in exchange for the shares.

Admittedly, these three stock redemption recommendations are technical, but they directly relate to the attractiveness of small businesses to the extent that technical questions such as these impair the businessman's ability to withdraw from the company.

They make it less likely that a person will commit his funds and devote his efforts to the business in the first place.

Another area of tax law which vitally affects small businesses relates to the pension and profit-sharing plan area. Without getting into ERISA, which is a subject entirely unto itself, I would like to take this opportunity to observe that many small businesses and professional practitioners have been adopting strained organizational structures in order to achieve tax benefits available to corporate employees but not available to self-employed individuals, including members of partnerships.

This is the direct result of the fact that the tax advantages of so-called H.R. 10 plans which are available to self-employed individuals are far less attractive than the tax advantages available to corporate employees.

In 1973, the American Bar Association adopted a tax section recommendation which provides that qualified employee benefit plan provisions of the Internal Revenue Code should be rewritten, first to eliminate all distinctions between common law employees and self-employed individuals, second, to eliminate any distinction based upon ownership, and third, to provide that special social security integration rules for owner-employees be eliminated or raised.

In 1978, the association's Special Committee on Retirement Benefits presented a recommendation approved by the house of delegates that the code be amended to eliminate the difference between the treatment of self-employed persons and employees with respect to qualified employee benefit plans and all other employee benefits.

But in any event, the limitations on contributions to or benefits from qualified employee benefit plans should be the same for both employees and self-employed persons, and further, that adjustments for increases in cost of living for self-employed persons should be provided, just as they are with respect to plans for employees.

The above recommendations in the employee benefit area would very substantially reduce complexity and provide comparable benefits to self-employed persons without subjecting them to the costs and distortions of using the corporate form in areas where, from a business standpoint, it is unnecessary and undesirable. Accordingly, these changes should be of substantial benefit to the small business community.

Finally, an area of the tax law which has long needed simplifying for the advantage of all taxpayers, including small businesses, involves the constructive ownership rules of the code, that is, situations where, for purposes of applying various code provisions, a taxpayer is regarded as owning shares of stock which he does not directly own but which are owned by certain related parties, such as members of the family, partners, fellow shareholders, and the like.

The basic code provision dealing with constructive ownership is section 318. However, scattered throughout the code are many provisions which contain different rules.

In 1969, the house of delegates approved a tax section recommendation which proposes a single set of constructive ownership rules. The subject is admittedly complex and, in many cases, involves policy decisions concerning the impact on different taxpayers of the relevant code sections.

Nevertheless, it is confusing for a taxpayer to weave his way through the assorted constructive ownership rules. The problem has not achieved a high enough priority to provide a specific legislative response to this proposal.

It would, however, be a substantial advantage to the small business community to develop legislation to straighten out and simplify this complex area of the tax law.

In conclusion, I think, Mr. Chairman, I would like to note the ongoing activity of the tax section as it relates to the simplification of the tax laws in the context of these hearings, which emphasize the small taxpayer situation.

The tax section is currently planning a small taxpayer conference which will consider changes in the law and administrative practice for individuals with relatively low adjusted gross income as well as businesses having relatively small gross receipts. We will be glad to keep you and your staff informed as plans for this conference proceed.

Its orientation will be simplification.

To the extent simplification is achieved, there will be obvious benefits to small business taxpayers, even without enactment of specific provisions for special treatment because of the small business classification.

From a simplification standpoint, the virtue of which is a less complex, less onerous and more equitable tax system, it is generally not desirable to establish separate categories and classifications of taxpayers to receive particular described benefits.

I do thank you, Mr. Chairman, for the opportunity to speak out on these items, and to express our views.

Senator BYRD. Thank you, Mr. Walker. I might say at this point that the tax section of the American Bar Association has been very helpful to the Senate Finance Committee in the last few years in focusing attention on areas of the tax code that need to be simplified and in making recommendations in that regard.

Thank you.

Mr. Corneel or Mr. Murdoch, who is next?

STATEMENT OF FREDERIC G. CORNEEL, ESQ., BOSTON, MASS.

Mr. CORNEEL. I very much appreciate the opportunity to appear before you. As a lawyer I am used to taking the law as I find it and it is a very unusual opportunity to look at it from your point of view, and that is to try and see the law as it ought to be.

When I do take that view, the first thing that struck me is that the law too often reflects good income tax theory but does not work out in practice, and I would like to give just two examples of that.

We know that the tax has to reflect our ability to pay. The budget that you mention works out to a tax of something like $2,500 for every person in the United States, and certainly there are lots of families of four who cannot afford to pay $10,000 a year.

So we know the law has to reflect our ability to pay.

The income tax assumes that income is a good measure of our ability to pay. The trouble is that we do not pay our taxes with income. We pay our taxes with cash. And income and cash are not the same thing.

If I decide to go into the used car business and I buy a car for $5,000 and I sell it for $6,000 that is great. I have made $1,000 profit but with inflation I now take the $6,000 and buy another used car in order to sell it again.

If that is my situation when the time comes to pay taxes, I do not have anything with which to pay the tax because my money is in the car. Some of the proposals that are before you, some of the proposals I would like to urge on you, would get away from income as the measure of our ability to pay, that is, reflect cash flow that goes into building up the business and therefore is not available to pay taxes.

Another point where theory and practice do not jibe has to do with fair market value. Somehow, the law thinks that everything there is has a fair market value and it taxes that fair market value.

And sometimes, like when somebody dies, you have to do that. You have to ask what is this estate worth? But in the income tax, that is not necessary. The assumption of fair market value is entirely contrary to fact in a closely held business. Its stock just does not have any fair market value.

Closely held businesses are not bought and sold. Very often they are liquidated, which is to say they are broken down into real estate and machinery and component parts which can be sold and therefore do have a fair market value.

But the business, as a going business, does not have an ascertainable fair market value, and that is especially true when it comes to a minority interest.

I know that from personal experience. I have a 3-percent minority interest in a business. No dividends are paid on this stock. The owner takes most of the profits as a salary and some of it he puts back in the business. It may be when he retires he will sell out and then maybe I will get something, but I do not know: He is younger than I am and so the chances are that my wife will have to come to the fellow after I am dead and ask what will you give me for this 3 percent interest? And whatever he will give her, that is what she will have to take.

Senator BYRD. If I could interrupt you at that point, actually, then, there is really no market for that stock.

Mr. CORNEEL. There is no market.

Senator BYRD. No one would buy into something like that.

Mr. CORNEEL. That is right, and where there is no market, I think the tax law is crazy to say that it has a market value—that is, to assume a ~~market value~~ for something that has no market and to have taxes turn on that just strikes me as wrong.

You have a bill, for instance, dealing with incentive stock options and they turn on whether the option price is 100 percent or 110 percent of fair market value? I think all of us here have had the experience of negotiating when somebody has died relating to the estate tax value of closely-held stock. We usually start very much from the low side and then the Government triples it and then we dicker and we come out somewhere. But that is no way to run income tax.

That takes time and it leads to tax avoidance and it makes for uncertainty if the law turns on something which does not exist in fact.

So here are two areas where I would say it really would be worthwhile for the tax law to get away from theory and to get down to something that makes practical sense.

Now, the specific proposals I have, I hope that altogether they end up in a balanced budget. Some would give something to the small businessman in the way of saving taxes, some would take something away, but I hope I am not just taking.

The first one, though, I would be taking, and that is there is a section 1244 in the code now which says if I put money into a small business within certain limits and then I sell that stock at a loss, that loss is an ordinary loss.

I think it is worthwhile thinking about changing that section 1244 to recognize that when I put money into the business I have reduced my ability to pay taxes. I certainly have less cash and what I have in its place, namely the closely-held stock, has a very uncertain value.

It would provide a real incentive if, within the limits of section 1244, $50,000 a year, investments in small business could be deductible. On the other hand, if the stock is sold, any money coming back would be ordinary income up to the deduction that had been taken.

My second proposal is really something where there is something wrong with tax theory and tax practice and that is that the law now does not permit us to deduct the cost of starting of business.

If I want to get a license to go into the small loan business or if I am a doctor and I want to buy a practice, or if I want a TV network affiliation contract, whatever I spend to go into the business, I am not permitted to deduct it. The theoretical reason for that is, that, I do not know how long I am going to be in business and therefore I cannot pro rate the costs.

But if I spend $25,000 to go into some business, it is clear to me that as that business makes money for me, some part of every dollar I get back is a return of my investment.

I think that across the board there should be some kind of a rule—and I do not know whether you want to take a 5-year rule or a 4-year rule or a 10-year rule, but something which recognizes the fact that money that we spend to go into business is money spent and is an expense of the taxpayer.

I would like now to turn to proposals for accelerated depreciation, and I know you have some before you that according to the estimates that I saw have a revenue cost of $50 billion.

Surely those proposals make some sense, because if I spend money to buy a truck, for instance, I really do have that much less money with which to pay taxes. But I think, unless you want really a huge hemorrhage in the tax system you have to put limits on those proposals and I would like to suggest two.

The first is we do not have to permit accelerated depreciation on all money that is spent without limit. Right now, we have first year depreciation which is limited to $10,000 per individual or $20,000 for a family.

I would think you could raise that limit to some higher amount, $25,000 or $50,000 or $100,000—some kind of a limit that would help small business. But you do not have to permit accelerated depreciation for million- and billion-dollar investments.

The other thing is this. The reason for permitting accelerated depreciation is this: I have spent my money to buy a truck, therefore, I do not have money to pay taxes and therefore I ought to get some quick deduction in computing my income tax for the money that I have spent. But that is true only, is it not, if I have spent the money?

Suppose I have borrowed the money? I have just as much cash as before. If I buy a truck for $15,000 and borrow the whole amount, I have got just as much cash as I had before.

My ability to pay taxes has not been reduced. A lot of mischief in the tax shelter area is due to the fact that we are permitted to take deductions, depreciation deductions and other deductions, based on borrowed money.

I support proposals for accelerated depreciation, but only to the extent that people are spending their own money. I think if you want to help people with their cash flow problem, where you have to help them is where cash flow goes to pay taxes and not in situations as are advertised in tax shelters where they say, you put $1 into this deal and you will get $5 in cash flow back.

The reason for this is that accelerated depreciation now is based on borrowed money that should be changed.

As my next proposal, I would just like to repeat what Mr. Walker said. It is not right—it does not strike me as right, at least—that you discriminate between people's ability to have the benefit of pension and profit-sharing plans. Self-employed people, partners, subchapter S shareholders right now can save $7,500 a year on a deductible basis. But if I were a corporate employee, I could save $36,000 a year or I could build up to a pension of more than $100,000 a year when I retire, or I can even get a combination of both.

That is just a tremendous disparity, and I do not think it is justified. I think that the need of small business people to have savings is at least as great as people who work for large corporations, or for the Government. I just do not think it is right to have that difference.

I would like to refer now to a point I made at the outset, and that is that closely-held stock does not have a fair market value. Assume that I want to give a key executive in my shop some stock. I do not care to get money for it. I just want him to have it to provide the incentive.

He has to pay taxes on it. If he is in the 50 percent bracket, he has to pay 50 percent of the hypothetical value of that stock which really means 50 percent of whatever the Service says the stock is worth. He may not be able to do that, and I know of situations where people do not take stock just because they cannot afford to pay the taxes on it.

We have got complicated law under section 83 which deals with that.

I would very much support proposals which say: Do not tax the fellow at all when he gets the stock. Wait with the tax until he sells it. But it would say, on the other hand, do not give the business a deduction for this stock. The business is not any poorer because the executor has become a shareholder.

Here you have a corporation. The corporation, as a corporation, does not care who owns its stock. It is not any poorer. Why should it have a deduction? Why should the individual have to pay money on a value that is uncertain?

Let's wait until he turns it into cash. This proposal would generate taxes rather than lose it, but it would work out from a business point of view.

Well, I see my time is up. In my written submission I have other suggestions that I wish people would look at this.

One specific suggestion I would like to make while my yellow light is on, is to work toward the concept of a small business corporation, a closely-held corporation which does not have marketable securities outstanding.

Tax its income just once, at the shareholder level, like subchapter S does. But the difficulty with subchapter S right now, and the reason why it is used so little, is that it does not have the corporate surtax exemptions.

And so if you go the way of taxing business income just once at the shareholder level, work out tax rates which reflect what is going on now with regular corporations rather than to have the high individual taxes which are now paid on subchapter S income. Thank you for the opportunity of sharing these thoughts with you.

Senator BYRD. Thank you, Mr. Corneel.

Mr. Murdoch, that brings us to you. We are glad to have you back.

Mr. MURDOCH. Thank you, Mr. Chairman. It is always a pleasure to appear here. I have always enjoyed my appearances here, but up until now I have been a self-invited guest and felt welcome. Now I am an invited guest and I not only feel welcome, but flattered and pleased to be here.

Senator BYRD. We are glad to have you.

STATEMENT OF CONVERSE MURDOCH, ESQ., WILMINGTON, DEL.

Mr. MURDOCH. I am particularly pleased to be asked to speak on what I guess is my favorite topic that is the problems of small businesses.

I was a delegate to the White House Conference on Small Business. At that conference there was some feeling among some of the delegates that there ought to be an all-encompassing definition of small business. I said then, and I say now, that I do not think it is possible to have a single definition of small business which can be used in every area of legislation or regulation.

However, for purposes of analyzing my comments today, I think it is fair to the subcommittee that you know what I am referring to when I talk about small business.

I am talking about a business which is owned by a few individuals. Usually they are members of a single family or those owners who are active participants in the day-to-day operation of the business.

The type of small business for which I have a concern has none of its equity or debt securities actively traded. There is no market for them. This goes back to Mr. Corneel's comment. It is theoretically fun to talk about the fair market value of these small business securities, but it is illusory. Such a fair market value does not exist. You cannot find it.

Next, the kind of small business that concerns me is one which is dependent for its capitalization on loans from its owners, on bank borrowings or on retained earnings in order to finance just staying afloat today. Such a business certainly depends on the same sources of capital for any expansion.

My next comments are made to the small business community rather than to the Congress. I urge the small business community to not come up with wish lists. When I talk about wish lists, I am not talking about the sort of topics that my fellow panelists mentioned this morning.

At the White House Conference on Small Business there were a lot of resolutions adopted. Unfortunately, the White House Conference did not have available to it what your subcommittee has available in the way of economists and technicians who can give you revenue estimates on various proposals. Therefore it was very simple for the delegates at that conference to just vote in favor of anything to reduce taxes.

We did not have the responsibility which you gentlemen have of trying to fit those proposals into a budget. Also we were not faced with the political realities which face Congressmen and Senators, namely, a proposal has to be something that can be sold to the voters.

Instead of coming up with wish lists, my plea to small business is to come up with proposals give them priorities and say, of all the proposals, this is the number one for us, this is number two, number three, and so forth. If you can afford to give us relief, do it up here at the number one level before you move down to the number two level.

My first priority would be proposals which do not cost the Government a dime. I think it is self-evident that any proposal which will help small business and will not hurt the Government at all should be considered as a number one priority.

Among the bills that you are considering today, S. 2171 is a good example of what I am talking about. That is Senator Nelson's proposal to eliminate the need for businesses to give a W-2 form to an employee who terminates his employment during the year.

I cannot believe that the enactment of that bill could possibly affect the Government's revenue. But it is a helpful thing—particularly for small business people—to be relieved of extra bookkeeping chore. I urge that as a good example of what I am talking about.

I cannot think of a single argument against the enactment of that bill. I have been fooled before and maybe the Treasury people can come up with something that indicates it is a terrible drain, but I cannot believe it.

In line with this same——

Senator CHAFEE. Could I interrupt with a question? I am not sure I get that suggestion. It is to relieve the small employer from giving a W-2 form to an employee who leaves during the year? Is that it?

Mr. MURDOCH. Yes, sir.

It is addressed to all employers. It is not limited to small business.

Senator CHAFEE. OK. All employers.

Would they give them the W-2 form what, at the end of the year? Mail it to them?

I am not sure I get the proposal.

Mr. MURDOCH. Yes. Under existing law, if an employee terminates, let's say June 30, the employer is required to give them a W-2 form, I believe it is within 30 days of termination. That is completely out of phase with what the employer usually does. The employer usually tells the bookkeeping department, sometime in January of the following year: Give everybody a W-2. This bill would say, unless the terminated employee specifically requests an early W-2, the employer is free to give everybody, including terminated employees, the whole schmeer of W-2's in January of the following year.

Senator CHAFEE. Is that a significant saving for an employer to not do that? I mean, is that not de minimis?

Mr. MURDOCH. I agree that, in the whole scheme of things, it is de minimis. It is a half an hour of our bookeeper's time that is not taken up in June or July getting out an extra W-2.

And I believe, with the Chinese, that a thousand mile journey has to begin with a single step. If you can have something as simple as this relief which gives anybody any help and does not cost the Government anything, I say let's take that step.

Senator CHAFEE. OK. I was wondering if there was more there than met the eye.

Mr. MURDOCH. No, sir. That is why I say I could not think of a single argument against it. I like to try to think of arguments against somebody else's ideas, but I could not.

Again, on things that have high priority and costs no revenue. I urge that there constantly be an effort to simplify the law, not only simplifying existing law, but analyzing all proposals for changes in the law to see if it is necessary to have them in a complex form or whether they can be just as workable with no cost to Government but in a simple form.

Another example of something that does not cost the Government a dime of overall revenue is for the Congress to blow the whistle on the present Treasury proposal to increase the frequency of paying over withholding and employment taxes.

As I understand the present Treasury proposal, if an employer pays as much as $13,000 a quarter—that would be $1,000 a week in employment taxes—the employer would have to go from a once a week deposit of employment taxes to a twice a week deposit. I can understand how sitting at the Treasury level and looking down at billions of dollars and with the interest rate on Government obligations running at 15 and 16 percent, why getting that much money in twice a week rather than once a week could be important from the Treasury's viewpoint.

But I believe it is up to Congress to look at this, not from just the Treasury's point of view, but from the point of view of the small employer. If you take a small employer who has $1,000 a week and say to him, you have got to pay that over twice a week rather than once a week because you are making interest on our money for 3 days, you are saying to him that you have $500 of the Government's money for 3 days. If you invested that $500 at 15 percent you would make 62 cents in 3 days.

Our clients do not have the time to fool around with that. For 62 cents, they cannot afford to pick up the phone and call the bank and say move it from a checking account to a savings account, much less trying to fool around trying to get money market funds to accept investments of $500.

Budget trickery is the only point to the Treasury proposal which I can see. It is to help balance this year's budget by moving some of what would otherwise be next year's receipts into this year's receipts just to make the budget look more balanced. It does not affect the Government's overall revenue. That kind of gimmickry does hurt small business.

The next proposals I would urge, would cost the Government revenue. In that department, my top priority would be a reduction of the corporate income tax rates in the lower ranges.

It was very helpful a couple of years ago when Congress graduated the corporate rates up to the $100,000 level. One of the bills that your subcommittee is considering would increase that surtax level to $150,000. In reading the staff summary I was very pleasantly surprised to see how little revenue effect that increase has.

I am convinced that that kind of proposed tax reduction, is the most meaningful to the type of business I am talking about. That is much more meaningful than an accelerated depreciation proposal.

An accelerated depreciation proposal is helpful to businesses which are capital intensive and which have access to capital to invest in capital equipment.

Most small businesses do not enjoy that privilege. They are scraping along. They just have enough to hang in there. It used to be, up to one year ago, you could say: Why don't you go to the bank and borrow enough to buy a truck.

That is practically out of the question now.

When you say to a small businessman, go to the bank and borrow $15,000 to buy a truck, he says: The bank tells me the interest rate is 22 percent, and my accountant tells me I am only making 15 percent on my invested capital. Why should I go borrow at 22 percent to earn 15 percent? I will just pull in my horns and weather out the storm.

Accordingly, accelerated depreciation is no help at all to that person. The help he needs is to lower his taxes so he can generate out of his own earnings the money to invest in new equipment. That, to me, is the number one priority in the area where it will cost revenue.

Another proposal that I have set forth in my statement is to either eliminate or drastically change the penalty tax on accumulation of surplus. That was never designed to be a revenue producer.

The tax itself is merely meant as a threat to force small businesses to disgorge their profits to their shareholders. If there was ever a need for that, I question whether that need now exists.

The threat of that imposition of a penalty tax on accumulation to surplus puts a premium on minutes which reflect plans for expansion and puts a penalty on the poor guy who does not turn to a lawyer to write his minutes up for him. The revenue agent involved says: you tell me you were accumulating a surplus to get into a new business. Show me in the minute book where it is.

You cannot because the guy does not have a minute book. He is having a meeting of the directors every time he is shaving.

The revenue agents expect him to keep minutes such as the DuPont executive committee keeps.

It is a terrible penalty on small business to continue that tax. If it is to be continued, I urge that the committee consider raising the $150,000 safe harbor exemption and indexing that for inflation. It is an absolute must.

Of the proposals you have before you today the one which has the lowest priority is the stock option proposal. To me, that is a nothing thing for small business.

Mr. Corneel has said you cannot find out the fair market value of interests in small businesses, particularly of minority interests. The small businesses which I am familiar with have absolutely no interest in stock options for their employees.

That is a great break for big businesses which have listed stock. You can pick up the Wall Street Journal and find their value yesterday but it is of no interest to small businesses of the kind with which I am familiar.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you, Mr. Murdoch. I want to make one observation and ask one question and then I will yield to my colleague from Rhode Island, Mr. Chafee.

Mr. Murdoch, you urged small business not to submit to the Congress a wish list and I want to echo your statement in that regard. I think as I see it, what should be done is to pick out two or three or four of the higher priority items and concentrate on these items rather than send a multitude of proposals dealing with taxes and capital formation.

The second thing—you mentioned a reduction in taxes for small business and you mentioned increasing from $100,000 to $150,000 the amount before reaching the top corporate vote. I assume that you are dealing with that increase from $100,000 to $150,000 rather than reducing the lowest rate, which is now what, 17 percent?

Mr. MURDOCH. Yes, sir.

Senator BYRD. You were not recommending reducing that rate?

Mr. MURDOCH. Not necessarily, although the bill before you would reduce the lowest rate from 17 percent to 15 percent and I am not one to oppose that kind of thing, but I do not consider a 17 percent income tax rate on the first $25,000 of corporate income as terribly onerous. 15 percent is better, but I cannot tell you that 17 percent is hurting badly.

Senator BYRD. But you think the better procedure, if you had to choose one to the other, the better procedure would be to increase to $150,000 the amount before you get into the surtax.

Mr. MURDOCH. Yes, sir.

Senator BYRD. Thank you.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Murdoch, I share your enthusiasm for 2136. I have a bill very similar to it in which in your statement you rank that of the most needed of all the bills.

I personally do not have your enthusiasm though for indexing. I am leery of indexing and I think most of the committee is. We feel indexing is building inflation into one more facet of our economy and I personally am reluctant to do that.

But I do not have the revenue figures right before me on that. You indicate that they are surprisingly small.

You refer to page 45. Page 45 on what?

Mr. MURDOCH. In the staff analysis.

The bottom of page 45.

There was a time when I thought $1 million was a lot of money and this is a lot of millions, but in the scheme of things it does not seem very large to me—particularly when you compare it to accelerated depreciation where you are talking about many billions of dollars of revenue loss.

Senator CHAFEE. With the 10-5-3.

Mr. MURDOCH. Yes, sir.

Senator CHAFEE. So you give this your number one priority?

Mr. MURDOCH. Just behind anything that simplifies compliance and does not cost the Government any revenue. Yes, sir.

Senator CHAFEE. Fine.

Thank you, Mr. Chairman.

Senator BYRD. Thank you gentlemen, very much.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 602.]

AMERICAN BAR ASSOCIATION

STATEMENT OF

CHARLES M. WALKER

before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

of the

UNITED STATES SENATE

on the subject of

PROPOSALS FOR THE ENCOURAGEMENT
OF SMALL BUSINESSES
THROUGH TAX REFORMS
AND
DEBT MANAGEMENT

APRIL 1, 1980

My name is Charles M. Walker. I am Chairman of the Section of Taxation of the American Bar Association. In that capacity, I am pleased to express the views of the American Bar Association and the Section of Taxation on tax proposals which would encourage small businesses.

The announcement of these hearings identified several bills on which the hearings would focus, and also stated that testimony need not be restricted to those particular bills. It indicated comments were welcome on matters of importance to the small business community including other tax proposals and current problems in the tax area confronting small businesses which have not been addressed in legislation.

Neither the Association nor the Tax Section has adopted a position on the subjects covered by any of the bills except S. 2168. I will, therefore, comment only on that bill. In addition, I will respond to the invitation to comment on other tax matters of importance to the small business community.

Tax policy adopted by the American Bar Association has addressed these issues in two different ways. One is by recommendation of specific changes in the tax law. The other is by recommendation that a program be established to simplify the Internal Revenue laws. Attached as Appendix A is the text of that simplification recommendation.

Over the years the Section of Taxation has recommended, and the House of Delegates of the American Bar Association (the Association's policy making body) has adopted, a large number of recommendations to change tax laws for the various reasons set forth in reports which accompanied the recommendations. I have with me for distribution to the committee and its staff several copies of a booklet summarizing those recommendations. Several of the recommendations, if adopted, would be of substantial aid to the small business community.

Among the proposals is a recommendation which has the same objective as does S.2168. Our recommendation is identified as Tax Section Recommendation 1975-5. It recommends that the number of shareholders in an electing small business corporation under subchapter S should be increased to 30. S.2168 provides an increase to 100. That is a move in the same direction--it merely goes further.

The present limitation of 15 shareholders interferes with flexibility in financial planning and business management by unduly restricting the corporation's ability to raise capital or to award stock to key employees. The limitation also prevents many businesses from benefiting from the subchapter S purpose of achieving the non-tax objectives of incorporation without incurring a corporate tax. The development of automated methods of correlating information on the returns of such corporations with the returns of their shareholders on audit has made unnecessary the administrative convenience of keeping such close limits on the number of shareholders.

Neither the Tax Section nor the Association has considered the portion of S.2168 which deals with the ability of a subchapter S corporation to issue an additional class of stock.

The subject of subchapter S corporations clearly is of interest to the small business community, The whole area needs re-examination in depth so rules can be simplified and made more easily usable by small businesses. Indeed, a re-examination of the subchapter S rules has been under way for some time by the staff of the Joint Committee on Taxation. The Section of Taxation's Committee on Subchapter S Corporations has been working with the staff and with Treasury representatives on evolving a revision of the rules. The revision is long overdue. I hope that it can be raised to a suitably high priority to enable definitive action in the near future.

Meanwhile, over the years there have been several legislative recommendations affecting the subchapter S provisions which have been proposed by the Tax Section and approved by the House of Delegates. These are summarized in Exhibit B attached hereto. Briefly, in addition to providing for an increase in the maximum number of permitted shareholders, they are designed (1) to permit a subchapter S corporation to own stock in an inactive subsidiary, (2) to permit an estate in bankruptcy to be a shareholder of a subchapter S corporation, (3) to eliminate the requirement that a subchapter S corporation have no more than 20% of its gross income from passive investment income, (4) to correct certain technical defects in the definition of subchapter S status, and (5) to modify the rules relating to distributions by subchapter S corporations.

Clearly, when approaching legislation in the subchapter S area, it would be highly desirable to do more than handle only one or two isolated problems. The ABA recommendations have evolved over the last five years and represent the current position of the Association. Precise statutory language has been proposed for each of them, which can be provided to the subcommittee's staff as desired.

If an early revision of subchapter S, in which the ABA recommendations doubtless would be considered, appears unlikely it is highly desirable to move forward now with these specific recommendations.

Another area of the tax law of interest to the small business community relates to the redemption of stock of closely held corporations. In that respect, there are three recommendations comprising Association policy, all recommended for attention. Appendix C provides a summary of them. Again, statutory language has been prepared, and can be made available to the Committee as desired. Some of the recommendations go back a good many years but are still viable and worthy of enactment. One of them provides that a redemption of stock which qualified as a complete termination of interest (thus insuring the redemption proceeds against treatment as an ordinary dividend) should not lose such status merely because the shareholder reacquires stock in the corporation during the following ten-year period through enforcement of his rights as a creditor.

Another recommendation relating to redemptions extends the period within which an agreement must be filed notifying the Internal Revenue Service of a reacquisition of stock after a redemption qualifying as a complete termination of interest. The present law requires such an agreement to be attached to a timely filed return for the year of the distribution. The recommendation is to permit the filing of the agreement with the first return filed for that year whether or not timely or whenever reasonable cause for failing to file the agreement with the return can be established.

The third recommendation in the stock redemption area adds the basis of the stock redeemed to the basis of other stock owned by the shareholder in cases where the distribution proceeds are treated as a dividend received instead of proceeds in exchange for the shares.

Admittedly, these three stock redemption recommendations are technical, but they directly relate to the attractiveness of small businesses to the extent that technical questions such as these impair the businessman's ability to withdraw from the company. They make it less likely that a person will commit his funds and devote his efforts to the business in the first place.

Another area of tax law which vitally affects small businesses relates to pension and profit-sharing plans. Without getting into ERISA which is a subject entirely to itself, I would like to take this opportunity to observe that many small businesses and professional practitioners have been adopting strained organizational structures in order to achieve tax benefits available to corporate employees but not available to self-employed individuals, including members of partnerships. This is the direct result of the fact that the tax advantages of so-called HR-10 plans which are available to self-employed individuals are far less attractive than the tax advantages available to corporate employees.

In 1973 the American Bar Association adopted a Tax Section recommendation which provides that qualified employee benefit plan provisions of the Internal Revenue Code should be rewritten (1) to eliminate all distinctions between common law employees and self-employed individuals, (2) to eliminate any distinctions based upon ownership and (3) to provide that the special social security integration rules for owner/employees be eliminated or raised.

In 1978, the Association's Special Committeee on Retirement Benefits Legislation presented a recommendation, approved by the House of Delegates, that the Code be amended to eliminate the differences between the treatment of self-employed persons and employees with respect to qualified employee benefit plans and all other employee benefits; that, in any event, the limitations on contributions to or benefits from qualified employee benefit plans should be the same for both employees and self-employed persons; and further, that adjustments for increases in cost of living for self-employed persons should be provided, just as they are with respect to plans for employees.

The above recommendations in the employee benefit area would very substantially reduce complexity and provide comparable benefits to self-employed persons without subjecting them to the cost and distortions of using the corporate form in areas where, from a business standpoint, it is unnecessary and undesirable. Accordingly, these changes should be of substantial benefit to the small business community.

Finally, an area of the tax law which has long needed simplifying for the advantage of all taxpayers, including small businesses, involves the constructive ownership rules of the Code, i.e., situations where for the purposes of applying various Code provisions a taxpayer is regarded as owning shares of stock which he does not directly own but which are owned by certain related parties such as members of the family, partners, fellow shareholders, and the like. The basic Code provision dealing with constructive ownership i section 318. However, scattered throughout the Code are many provisions which contain different rules.

In 1969, the House of Delegates approved a Tax Section recommendation which proposes a single set of constructive ownership rules. The subject is admittedly complex and in many cases involves policy decisions concerning the impact on different taxpayers of the relevant Code sections. Nevertheless, it is confusing for a taxpayer to weave his way through the assorted constructive ownership rules. The problem has not achieved a high enough priority to provide a specific legislative response to the Association's proposal. It would, however, be of substantial advantage to the small business community to develop legislation to straighten out and simplify this complex area of the tax law.

Finally, Mr. Chairman, I would like to note the ongoing activity of the Tax Section as it relates to the simplification of the tax laws in the context of these hearings with particular emphasis on small taxpayers. We are currently planning a small taxpayer conference which will consider changes in the law and administrative practice for individuals with relatively low adjusted gross incomes, as well as businesses having relatively small gross receipts. We will be glad to keep you and your staff informed as plans for the conference proceed. Its orientation will be simplification. To the extent simplification is achieved, there will be obvious benefits to small business taxpayers, even without enactment of specific provisions for special treatment because of the small business classification.

From a simplification standpoint, the virtue of which is a less complex, less onerous and more equitable tax system, it is generally not desirable to establish separate categories and classifications of taxpayers to receive particularly described benefits.

Thank you, Mr. Chairman, for this opportunity to express these views.

EXHIBIT A

RECOMMENDATION #1976-1

A program to simplify the internal revenue laws should be established.

9 Tax L. 722 76-1 ABA Repts. ___ SIMPLIFICATION

There is general agreement that the internal revenue laws have, in many respects, become so complex as to defy comprehension; that uniform enforcement is virtually impossible; that compliance with these laws requires an undue expenditure of time and money; and that the complexity of these laws affects public confidence in our tax system and imperils the voluntary compliance upon which the system depends. Thus the internal revenue laws are in dire need of major simplification, and a comprehensive program is needed.

It is recommended that (1) the Congress simplify the internal revenue laws so that they can be easily understood and complied with and fairly and consistently administered; (2) the Ways & Means and Finance Committees adopt and announce a scheduled long-range program to achieve such simplification; (3) those Committees employ to the maximum extent possible the resources and experience of the Treasury Department in designing and developing such a program; and (4) the Congress designate and establish an appropriate body of advisers, whether it be a separately funded section of the staff of the Joint Committee on Internal Revenue Taxation, a separate commission, or some other appropriate organization, to assist in this program by assembling and analyzing basic information and advising the tax-writing committees of various alternatives.

63-769 O - 80 - 36

EXHIBIT 8
8-1

RECOMMENDATION #1976-12

Section 1371 An electing subchapter S corporation should be permitted to own stock in subsidiary corporations that do not engage in any business or have taxable income for the year, even if the subsidiaries engaged in business in prior years.

29 Tax L. 1180 77-1 ABA Repts. 106 SUB S CORPS

Section 1371(a) provides that a corporation will not generally be eligible to elect to be taxed pursuant to subchapter S if it is a member of an affiliated group as defined in section 1504. Section 1371(d) provides an exception if inclusion in the affiliated group is only by reason of ownership of stock in another corporation that has not, since the date of its incorporation and through the end of the taxable year in which the election is in effect, engaged in business, and has no taxable income during said taxable year. Thus, current law prohibits a subchapter S election by any corporation with a subsidiary corporation which has previously engaged in business, even though during the year of the proposed election the subsidiary is inactive and has no taxable income.

It is recommended that a corporation be permitted to elect to be taxed pursuant to subchapter S even though its subsidiary has previously engaged in business, so long as the subsidiary does not engage in business during any taxable year for which the election is in effect and has no taxable income for any period included within such taxable year.

RECOMMENDATION #1976-14

Section 1371 An electing small business corporation under subchapter S should be permitted to have as a shareholder the estate in bankruptcy of an individual.

29 Tax L. 1184 77-1 ABA Repts. 106 SUB S CORPS

Under section 1371(a) a "small business corporation" may not have as a shareholder "a person (other than an estate and other than a trust described in subsection (f)) who is not an individual." The Internal Revenue Service has ruled that "an estate", within the meaning of section 1371, does not include an estate in bankruptcy, and that the bankruptcy of a shareholder causes the termination of the subchapter S election. Tax policy considerations do not appear to make such an involuntary termination necessary, and Congress probably did not intend that the bankruptcy of a shareholder would destroy the election.

It is recommended that an electing small business corporation under subchapter S be permitted to have as a shareholder the estate in bankruptcy of an individual.

RECOMMENDATION #1976-10

Section 1372 — The requirement that an electing small business corporation under subchapter S may derive no more than 20 percent of its gross receipts from passive investment income should be eliminated.

29 Tax L. 1176 — 77-1 ABA Repts. 106 — SUB S CORPS

Section 1372(e)(5) provides, with limited exceptions, that the election of a small business corporation will terminate if, for any taxable year, more than 20 percent of its gross receipts constitute passive investment income. This prevents many active businesses from using subchapter S solely because the nature of their business is such that they have substantial receipts in the form of passive investment income. This provision, which is not necessary to further the purpose of subchapter S, often causes inadvertent termination when the arbitrary limit is exceeded.

It is recommended that subchapter S be amended to eliminate the requirement that an electing small business corporation may derive no more than 20 percent of its gross receipts from passive investment income.

RECOMMENDATION # 1978-13

in 1372 The Internal Revenue Service should be required to treat as an electing corporation under subchapter S a corporation the election of which would be terminated either as a result of an act or occurrence which was taken without knowledge that it would affect adversely the continuing status of the corporation as an electing corporation, if the act can be or has been cured, or as a result of a failure to meet a technical standard set forth in the statute, where the margin of such failure is not substantial, if the corporation and its shareholders have continued to treat the corporation as an electing small business corporation for all periods ending after the occurrence or after the failure to meet a technical standard occurred, as if no termination had occurred.

31 Tax L. 1498 79-1 ABA Repts. 107 SUB S CORPS

Termination of an electing corporation's status as a subchapter S corporation can occur involuntarily, and be retroactive to the beginning of the taxable year, either as a result of the corporation's failure to be a qualified electing corporation (e.g., a shareholder transfers some of his shares to family members, inadvertently creating more than the permitted number of shareholders) or as a result of its receipt either of more than 80 percent of its gross receipts from foreign sources or of more than 20 percent of its gross receipts from passive investment income. Frequently discovery of the terminating event occurs during an audit several years later. Meanwhile, the corporation and its shareholders have continued to file returns and pay taxes in the good-faith belief that the corporation's election under subchapter S has remained in effect.

The retroactive termination of an election under subchapter S usually results in substantial hardships. Inadvertent action by one shareholder may affect adversely the taxes owed by several others, and all the shareholders may suffer as a result of an accounting adjustment to gross receipts, or the vicissitudes of the timing of receipts close to the end of the taxable year.

It is recommended that relief from the hardship of such situations be provided by requiring the Service to treat the election as not having terminated when it determines that the corporation and its shareholders have treated the corporation as an electing corporation consistently during all intervening taxable years and certain other conditions are met.

RECOMMENDATION # 1978-14

Section 1375 A corporation which is or has been an electing corporation under subchapter S should be permitted to distribute to its shareholders, in money or in other property, amounts equal to the amounts which previously have been taxed to shareholders but have not been distributed to them, without regard to when such distribution is made and without regard to the earnings and profits of the taxable year during which the distribution is made. Such a corporation should be required to keep a separate earnings and profits account, to which undistributed earnings are credited and from which all distributions are treated as made to the extent of such account, and required to recognize gain or loss with respect to property other than money distributed in such circumstances where the fair market value of such property is different from the adjusted basis thereof, to the extent of the lesser of the amount of such previously taxed income or the amount of such difference, as the case may be.

31 Tax L. 1501 79-1 ABA Repts. 107 SUB S CORPS

Present law unnecessarily restricts the ability of a shareholder of an electing corporation to receive distributions equivalent to the amounts previously included in his gross income as his share of the electing corporation's undistributed taxable income. The present rules are highly complex and sometimes operate unfairly. Only when the electing corporation makes a distribution in money during the first two and one-half months of its next taxable year may a shareholder easily receive the earnings on which he already has been taxed. Otherwise, the electing corporation first must distribute its entire current earnings (which, for a corporation actively engaged in business, usually cannot be calculated until after the close of its taxable year, when it is too late to make the distribution). Moreover, if the corporation ceases to be an electing corporation, present rules require that all current and accumulated earnings and profits be distributed before a shareholder may receive any benefit from having included in his gross income his pro rata share of the corporation's earnings while it was an electing corporation. Even then, the benefit permitted (assuming the shares are capital assets in the hands of the shareholder) is reduction of capital gain, although the income was treated as ordinary income in the hands of the shareholder when earned by the corporation. Additionally, present rules treat previously taxed income as a personal right which may not be transferred by the shareholder. Accordingly, his estate or heirs and lifetime transferees may not treat a distribution from the corporation as a distribution of previously taxed income.

Such results may be unfair in many cases and are not essential to the operation of subchapter S. They are inconsistent with the purpose of aiding small business and spring from an unnecessarily complicated solution to a simple mechanical problem.

It is recommended that each electing corporation be required to keep a separate earnings and profits account at all times while it is an electing corporation. All its undistributed earnings would be credited to that account to the extent thereof, and thereafter would be treated under section 301 as if made by a corporation which was not an electing corporation.

It is further recommended that distributions in property other than money be permitted and that gain or loss be recognized by the distributing corporation in connection with such distributions.

EXHIBIT C
C-1

RECOMMENDATION #1961-2 (11450-26)

Section 302 A redemption of stock which qualifies as a complete termination of interest should not lose such status merely because the shareholder reacquires stock in the corporation during the following 10-year period through enforcement of his rights as a creditor.

14 Tax L. 37 88 ABA Repts. 346 CLOSE CORP PROB

Under Sec. 302(b)(3), if a corporation redeems its stock, a shareholder is assured of capital gain (and not dividend) treatment if there is a complete redemption of all stock in the corporation owned by him. While the rules for attribution of stock ownership apply in determining whether all his stock has been redeemed, stock owned by family members is not attributed if, among other things, the shareholder retains no interest in the corporation (other than an interest as a creditor) and does not acquire any such interest (other than by bequest or inheritance) within ten years from the date of distribution.

Although the prohibition against retention of an interest in the corporation does not apply to an interest as a creditor of a corporation, the regulations specifically provide that the acquisition of stock of the redeeming corporation as a result of the enforcement of rights as a creditor will be considered an acquisition of a prohibited interest.

It is recommended that Sec. 302 be amended to include an express provision that the termination of interest rule is not rendered inapplicable by virtue of an acquisition of stock through enforcement of rights as a creditor.

RECOMMENDATION #1963-3 (11450-17)

Section 302 The period should be extended within which an agreement must be filed notifying the IRS of a reacquisition of stock, after a redemption qualifying as a complete termination of interest.

16 Tax L. 80 89 ABA Repts. 284 CLOSE CORP PROB

Sec. 302(c)(2)(A) provides that the family attribution rules of Sec. 318(a)(1) are not to be taken into account in determining whether a shareholder's interest in a corporation has been completely terminated by a redemption of his stock (so as to qualify for capital gain treatment) if several conditions are satisfied.

One such condition is the filing of an agreement to notify the IRS of any acquisition of an interest in the corporation within 10 years of the redemption. Reg. § 1.302-4 requires that this agreement be in the form of a separate statement, in duplicate, signed by the shareholder, and attached to a timely filed return for the year of the distribution. The IRS strictly enforces these requirements. The courts have disagreed as to whether reasonable cause should excuse a late filing.

It is recommended that filing of the agreement be permitted (1) with the first return filed for such year, whether or not timely, or (2) whenever reasonable cause for failing to file the agreement with the return can be established.

RECOMMENDATION #1976-6

Section 302 — **The Code should set forth rules for the disposition of the basis of stock redeemed or sold under circumstances which cause the proceeds of redemption or sale to be taxed as a dividend.**

29 Tax L. 1156 ~~77-1 ABA~~ Repts. 106 CLOSE CORP PROB
Amended 30 Tax L. 498

If a redemption of stock does not qualify for sale or exchange treatment under section 302(a), the proceeds paid by the redeeming corporation to the distributee shareholder are treated as a dividend distribution to the extent that the corporation has sufficient earnings and profits. Under section 304, certain sales of stock in one corporation to another corporation are treated as redemption transactions which may have dividend consequences. In such cases, no offset or reduction in the amount of the dividend is allowed to reflect the basis of the stock redeemed or sold. The Code contains no relevant provision with respect to the disposition of the basis of such stock, and existing regulations provide guidance in only a limited number of situations.

It is recommended that, in such situations, the basis of the stock redeemed or sold be added to the basis of other stock of the issuing or acquiring corporation actually owned by the distributee, or, if he owns no such other stock, that the basis of the stock redeemed or sold be treated as a loss from the sale or exchange of that stock; except that such loss shall not be allowed to a corporate distributee in respect of a distribution having as its principal purpose the avoidance of federal income tax, and, in such case, the adjusted basis of the stock which is redeemed or sold shall be disposed of in accordance with regulations to be prescribed by the Secretary or his delegate.

STATEMENT

OF

FREDERIC G. CORNEEL

BEFORE

THE SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
GENERALLY

April 1, 1980

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April 1, 1980

United States Senate Committee on Finance
Subcommittee on Taxation and Debt Management Generally

Dear Sirs:

I appreciate the opportunity to submit comments in connection with your current consideration of legislation to ease the tax burden on small business, an effort that I heartily endorse. Rather than direct my comments to specific and technical aspects of the bills, I will discuss them in the context of more general suggestions to improve the income taxation of small business.

I should say at the outset, that I am a partner in a firm that represents a number of small businesses, and am a director of small corporations. While this may color my views, they are my own and not those of my partners or of any client. I am also a member of various professional groups, such as the Tax Section of the Massachusetts Bar Association, of which I am past Chairman, and the Committee on Closely Held Corporations of the Tax Section of the American Bar Association. Again, I do not speak for these organizations.

SUMMARY

(1) The tax law should offer an incentive for investment in small business by revising 1244 so that rather than cushioning loss on sale of small business stock, it would encourage purchase of such stock.

(2) Small business suffers from cash shortages which are aggravated by a tax that is based on income rather than cash flow. Legislation should provide for faster depreciation deductions and also for the amortization of goodwill and business start-up costs.

(3) Pension plan benefits and fringe benefits of owner-employees of small businesses should be conformed to those now available to employees of large corporations.

(4) Stock ownership by key employees in small corporations should be encouraged by postponing tax on receipt of small corporation stock until that stock is sold. The corresponding deduction to the corporation on issue of the stock could be eliminated.

(5) A variety of measures should be considered to facilitate the continuation of a small business as a small business including an easing of redemption rules.

(6) The small business that requires tax relief is business that does not have outstanding marketable securities. A new tax concept should be introduced called "the Close Corporation".

(7) There should be only a single tax on the profits of a Close Corporation, similar to the present taxation of partnerships, except that pursuant to recommendation (1) above, there would be a deduction for monies reinvested in the Close Corporation. The rates on Close Corporation income would be substantially the same as are now payable by owners of small corporations on earnings taken in part as salary and in part left in the business subject to corporate tax.

(8) Simplification of tax laws should be promoted by making the Close Corporation tax system mandatory and by eliminating many of the elections now in the Code.

POLICY CONSIDERATIONS

I would like to begin by summarizing certain general policy considerations that should in my view provide the guidelines for tax legislation intended to assist small business.

Cash Squeeze. One of the basic tax problems for a small business is that the measure of the income tax is not available cash, but taxable income. But, since taxes must be paid with cash, cash rather than income is a better test of the ability to pay.

Particularly, a growing business is likely to run into cash shortages caused by the need to carry more receivables and inventory and to expand plant and equipment. A 50% income tax (Federal and State combined) makes it exceedingly difficult for small and growing business to respond to growth opportunities. A number of the suggestions set out below are intended to postpone the tax on income until the cash is more readily available.

Because I see the cash squeeze as the major problem of small business, I would limit tax assistance to businesses that do not have access to public security markets. Further, I would structure the aid so that it would reflect cash needs created by business expansion.

Lack of Market of Small Business Stock. A minority shareholder in a closely-held corporation has no assured market for his stock. In the absence of an agreement among the shareholders, he can, practically speaking, sell his stock only if the controlling shareholder approves or decides that the company should be sold. Few people are willing to commit their funds for the indefinite future and, therefore, in the absence of tax incentives, it is difficult for small business to attract capital. I believe such incentives should be given serious consideration.

Equally important, the tax law should recognize that stock that has no market cannot have any ascertainable fair market value. The current tax treatment of such stock, which is based upon an assumed fair market value, creates much mischief and should be changed.

Small Business Must Pay Fair Share of Taxes. Small businesses are not always in need of assistance. At least occasionally they grow to be large and their owners wealthy. There is no reason why in such situation, the owner and the business should not pay taxes on the same basis as others. And where a tax benefit has been conferred to help small business in times of difficulty, there is no reason that this benefit should not recaptured when it succeeds.

Because I see no reason why small business should not pay a fair tax when it can, I favor changes in the law that relate to the timing of income and deductions, rather than credits or rate reductions that result in a permanent lowering of the tax.

Simplification. The complexities of the tax law have not only made taxpayer compliance and tax planning unduly time consuming and expensive, but have I believe resulted in disrespect for the law, a lowering of standards of compliance and a substantial reduction in the efficiency of audits (because a complicated law is so much more expensive to enforce than a simple law). I will limit my comments to one of the sources of complexity, the elective provisions:

To assist taxpayers in general and small business in particular, Congress has over time created an enormous number of tax election provisions. As a result, businesses that are economically identical pay different taxes. By the same token, businesses that failed to make the right election are paying more taxes than Congress meant for them to pay. This is due to ignorance on the part of taxpayers and advisers and the fact that many of these elective provisions are complicated. Further, the paths to tax reduction that Congress has so kindly opened by the elective provisions are strewn with what courts have repeatedly called "traps for the unwary", but have nevertheless enforced.

I believe that Congress should decide as to the amount of taxes that are appropriate for a taxpayer in a given economic situation, provide for this tax in a law that is as simple as possible and eliminate most elections, no matter how well meant.

It would expand this letter unduly to list all of the provisions that might be eliminated under this approach. Below, I deal with only one, namely, the effect of choice of entity on the taxpayer. But, I would hope that the Committee will make simplification through reduction of tax elections a staff study project.

RECOMMENDATIONS

The foregoing very general observations furnish the background to more specific comments as to how the tax law might assist small business in various stages of its life.

(1) Financing Small Business. Many small businesses fail. Even if they do not, the investment in the business is entirely illiquid. A recent Tax Court case, recognizing the great reduction in value of an unmarketable security, held Fannie Mae stock which could not be sold for 15 years to be worth only 25% of the value of similar stock which was unrestricted. Eastern Service Corp., 73 T.C. No. 67 (Feb. 19, 1980). Stock in a small business is not subject to such legal restrictions, but as already indicated, such stock represents a dedication of capital for the indefinite future. It is like the farmer's seed in the ground; a plant may spring up, but the seed is gone.

The tax law now encourages investment in small business under Sections 1242 and 1244 by providing an ordinary loss deduction on disposition of the stock in the small business.

In my view, the tax law would much more closely correspond to economic reality and provide a more meaningful incentive if the investment could be deducted when made, either immediately or amortized over a short period of time. On the other hand, on sale of the stock the original deduction could be recaptured at ordinary income rates. Such tax treatment would permit small business to compete for the investor's dollar with such tax shelters as oil, housing, historical structures, leased equipment, etc.

To limit the revenue cost of this change, there could be dollar limits on the deduction by any taxpayer similar to those of Section 1244 (i.e., $50,000 per individual per year, $100,000 on joint return) and the deduction could be considered a tax preference item.

The present approach cushions the loss of investors in businesses that have failed. The approach I suggest would encourage the investment. I believe it is likely to be more effective because it is more direct.

Note on Pending Bills. S.487 and S.1481 (96th Cong. 1st Sess.) also would provide tax incentives for investments in small business. However, by providing a credit rather than a deduction subject to recapture, they result in a permanent and I believe unnecessary loss of tax revenue. In addition, I believe it is undesirable for Congress to prescribe the capital structure and securities to be issued by small business as S.1481 would do with respect to the Small Business Participating Debentures there proposed.

(2) Formation and Start-up Expenses. One of the great sources of mischief, is the law's insistence on the non-deductibility of expenditures if (a) they do not relate to an existing business or (b) if the benefit they produce does not have a measurable life.*/ As a result, no current deduction is permitted for the cost of going into a business or the cost of going concern value, goodwill, customer lists and the like when a business is purchased.

Our tax is supposed to be a tax on income. If you spend $10,000 to start a business, every dollar produced by that business represents in part a return of this investment, and that part is not income. Nevertheless, it is now taxed.

It is true that the ratio of cost to income cannot be measured accurately until the business is finished, but all accounting involves more or less arbitrary conventions. A return

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*/ There are some exceptions to this rule, such as the election to deduct or amortize research and development expenses (IRC §174) or to amortize the cost of organizing a corporation, a provision that is very narrowly interpreted by the Service (IRC §248).

of capital should not be taxed as income merely for lack of a convention.

I would recommend either an immediate deduction or a fast write-off of organizational expenses, start-up expenses and, where businesses are purchased, of the going concern value or goodwill.

(3) Depreciation. I believe an immediate expensing of capital expenditures would be the greatest possible boost Congress could give closely held businesses to help with their cash flow problems. If a business wants to grow, it must plow back its earnings into the business. But, if in a given year, a business earns $100,000 and puts it all back into the business without a deduction for the investment, it must pay a tax on money that it has spent. Requiring a deferral of the deduction means that growth must be deferred in order to pay the tax. This is a particular handicap to a newly organized business, since unlike existing businesses, it does not have an on-going stream of depreciation deductions to shelter at least a part of its cash flow.

Perhaps, the easiest way to accomodate this proposal in the framework of present tax law, is to increase the benefit of Section 179, which is entitled "Additional First - Year Depreciation Allowance for Small Business" even though it is not limited to small business. I would (1) increase the dollar amount from the present $10,000 - $20,000 to $50,000 - $100,000 and (2) eliminate 179(d)(8) which treats a partnership as a taxpayer.

If the justification for a speedy write-off of the cost of capital items is the cash squeeze, then debt financed acquisitions are not entitled to that support. A number of abuses in the tax shelter area stem from deductions based on debt, in some cases non-recourse debt. I would think it would be reasonable to limit accelerated depreciation to those situations where the amount invested in the business has increased more than the outstanding debt.

> Note on Pending Bill. S.1435 (96th Cong. 1st Sess.) also would permit a substantially faster write-off than is now available. Because, it would apply to all businesses and all sizes of investments, it is estimated, as I understand it, to have an adverse revenue impact by 1984 of about $50 billion. The proposal I submitted would have a much lesser effect on revenue (a) because of the proposed limit in amount and (b) because debt-financed acquisitions would not qualify.

(4) Pension Plans, Fringe Benefits. The owner-employee of an unincorporated business, partnership or a subchapter S corporation is limited in the percentage of his income that he can save in qualified plans much more strictly than an employee of a regular corporation.

> The owner-employee is generally speaking subject to the Keogh limit of $7,500 per year.

> The corporate employee may have (a) \$36,875 per year contributed under a defined contribution plan or (b) he can have built up for his account a fund sufficient to pay him on retirement an annual pension of \$110,625 per year or (c) he may have a combination of 140% of the maximum under (a) and (b).

This discrimination against owner-employees is particularly shocking if it is considered that the need for the security provided by such plans is much greater for the owner of a closely held business than it is for the employees of a government or large corporation. <u>The same saving opportunities should be made available for all who work for a living, regardless of for whom they work</u>.

Another inequity relates to <u>group term life insurance</u> and company paid <u>health insurance</u> for the owner-employee. These are currently deductible if the corporate form is used for the business, but not if a partnership is used. If a tax benefit is to be granted to these payments, it should be available to all regardless of the form used for the conduct of the business.

(5) <u>Stock Compensation Plans</u>. In many cases, the only way in which the owner of a closely-held business can attract and retain competent executives is by giving them a "piece of the action". Generally, however, the key executives simply do not have the net after tax funds with which to pay for the stock. The owners are often willing to "give" the stock to

the executive, but such a gift will be taxed to the executive as compensation based on its hypothetical fair market value. Therefore, if the executive is in a 50% bracket, he must pay in taxes to the government one-half the value of the stock given to him by the employer.

The current tax treatment of stock compensation is an impediment to providing the key executive the desired participation and gains the government very little in taxes. For if the gift is income to the employee, it is also a deduction to the company. Accordingly, if the business and the key executive are in roughly the same top brackets, which is often the case, there is no net tax revenue as a result of the transaction.

I would change this so that the executive does not have to pay tax on receipt of the stock and the business does not get a deduction. Both income and deduction could be deferred until sale of the stock, indeed, the deduction might be eliminated entirely.

Not only would this approach simplify the transfer of substantial equity to the key executive and thereby enhance the ability of small business to compete with big business in seeking to attract good people, it also makes economic sense: As indicated at the outset, if measured by what the stock might fetch if offered to an investor who does not work in the business and who does not control it, the stock would in many cases be close to worthless, simply because there is no market for a minority holding in a closely-held business.

As far as the issuing corporation is concerned, it can be said that as a corporation, it is not any poorer just because its ownership has changed. The stock of the other owners may be worth less by reason of the dilution, or it may be worth even more as a result of the good work of the executive stimulated by his or her acquisition of the stock. But, whatever the change in value of the other owners' interest, it will be time enough to measure and tax this when that interest is disposed of.

This approach of waiting with the taxation of the executive until he disposes of his stock, raises the question what part of the proceeds of the disposition should be taxed as earned income and what part as capital gain. Capital gain treatment to the employee and no deduction to the corporation would be a simple answer and result in no revenue loss.*/

*/ It would also be possible to have a more refined approach under which, if the disposition of the stock takes place shortly after its receipt, it would be taxed as earned income, but the longer the time between receipt and disposition, the larger the capital gain element. There could be provisions for tax when the stock becomes marketable or is exchanged in an otherwise tax-free reorganization; also, for income in respect of a decedent.

I cannot emphasize strongly enough how helpful the change here suggested would be. Section 83 as implemented by the recent regulations harbors untold complexities. Indeed, the two difficulties with the present approach are self-evident. First, it turns on the hypothetical fair market value of an asset that has no real market at all -- namely, the closely held stock. Secondly, it requires payment of a tax from one, namely the employee, who has no cash and no means to raise it.

> Note on Pending Legislation. S.2239 (96th Cong. 2d Sess.) provides for incentive stock options. It generally would achieve the same result for which I argue: capital gain for the employee and no deduction for the corporation. However, it is replete with what I believe to be unnecessary conditions, exceptions and limitations. In particular, it turns on the relation of the option price to the fair market value of the stock at the time of its acquisition. I repeat again, because I think it so important: Stock that is not traded in a market does not have a fair market value. Law should not turn on something that does not exist.*/

(6) Disposition of Business - Reducing Advantages of Big Corporations. The founder of a small business cannot stay in control forever. When he is ready to dispose of it, the purchaser more often than not is a giant conglomerate and the

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*/ The current draft law on the taxation of bankruptcy and the proposed regulations under §385 also depend on fair market value of securities without a market. Such provisions necessarily open the door to abuse and time-consuming and expensive haggling between the taxpayer and the IRS.

result is a loss in the flexibility, variety and democracy of our economy. The tax law should do what it can to improve the ability of existing small business to purchase in competition with the large corporations.

One great benefit that the tax law now confers on large businesses is the opportunity to make tax-free acquisitions with marketable securities. The founding father of the small corporation who disposes of his interest in a tax-free exchange, preserves his capital undiminished by the capital gains tax. It is true that his basis in the acquiring company's stock is low, but he can defer the tax, or spread it over the years or, through step-up in basis at death, avoid it entirely.

One way of dealing with the problem would be to make taxable all reorganizations which are in fact sales. When the stock of the corner garage is sold for shares of General Motors, it is meaningless to call this an "exchange incident to the readjustment of the corporate structure of a continuing enterprise". The stock of the garage has been converted into a security which at any moment can be converted into cash, as easily as a check can be cashed. Isn't the time of exchange the appropriate time to tax the appreciation in the stock of the garage?

Now, it may be objected, that while this approach may cut down the bargaining advantage of big corporations, since they are the only ones who now enjoy the benefit of tax-free exchanges in acquiring businesses, it unfairly discriminates against the small business owner as against other security holders who are entitled to make tax-free exchanges. One approach to deal with this objection would be to make all reorganization exchanges taxable unless the exchanging shareholders have a substantial interest, say at least 25%, in the continuing corporation.

In order to be effective, legislation directed against large corporation take-overs would have to cover cash purchases also. One approach would be to make the cash purchase of an unrelated business taxable as a dividend to the shareholders of the large corporation. (This is not as unreasonable as it sounds: I understand that some conglomerates have advised their shareholders of the tax benefit of using retained earnings to make acquisitions rather than to pay them out as dividends).

While these changes would tend to preserve small business as small business, they are not favorable to owners and investors in small business. Certainly, some individuals now invest in small business in the hope of reaping large rewards on an eventual merger with or sale to a large company. The changes discussed in this section would remove this incentive and as a result would make it harder for small business to attract capital. I would, therefore, recommend them only in the context of a general legislative effort to provide incentives for investment in small business.

(7) Disposition of Business - Redemptions. Regardless of whether roadblocks are placed in the way of the acquisition of small businesses by large businesses, something should be done to facilitate the disposition of the business to the "insiders" who helped build it rather than to strangers. In all such cases, the necessary funds must practically speaking come from the business and in most cases this involves the purchase by the corporation of its own stock, that is, redemptions. The present law makes this unnecessarily difficult in three respects:

(i) The law requires the redemption to reduce the redeeming shareholder's interest, including interest by attribution, to less than 50%. IRC §302(b)(2)(B). In many cases, the founding father would like to reduce his interest in the company gradually and equally gradually, somewhat on a trial and error basis, build up the interest of the executives who will take his place.

A way of dealing with this problem would be for the law to create something called a "substantial redemption plan". If there is a plan looking for a substantial reduction over a period of 10 or 15 years, then any redemptions pursuant to that plan would be taxed as capital gain. There would be a provision that if the plan were abandoned during that period, the tax would be recomputed at ordinary income rates.

(ii) Waiver of family attribution requires a complete termination of connection between the redeeming shareholder and the corporation. IRC §302(c)(A)(i) The founding father, however, may wish to continue as a director, perhaps even chairman of the board and it would be a benefit to the small business to have his guidance and counsel. I would recommend that the law be amended so that if the redemption or the substantial redemption plan reduces the redeeming shareholder's direct interest below 50%, he could still continue as an officer, director or employee.

(iii) By refusing to permit waiver of family attribution in situations where the stock is held by estates, the Internal Revenue Service puts an undesirable pressure on lifetime redemptions. It would be helpful if in this respect Congress would back the courts. Compare Rev. Rul. 68-388, 1968-2 CB 122 and Rev. Rul. 72-472, 1972-2 CB 202 with Lillian Crawford, 59 T.C. 830, Horace B. Rickey, Jr., 79-1 USTC ¶9322, 592 F.2d 1251 and Rodgers P. Johnson Trust, 71 T.C. 141 (1979).

(8) What is a Small Business. Congress has over the years sought to favor small business. But almost each time it has done so, it has defined small business differently. In subchapter S, it looked to the number of shareholders but did not care about the size. In section 1244, it cared about the size but not the number of shareholders. In section 303, it focused on the percentage of the estate represented by the stock interest, but did not care about the size of the company or

the number of its shareholders. Section 6166 which permits a 15 year deferral of estate tax, turns on the number of owners and the percentage of the voting power held by the estate. Paradoxically, section 6166A which permits only a ten year deferral, has even more restrictive rules in defining a closely held business.

It is doubtful that there are meaningful policy differences which shaped the different definitions of the business to which relief was to be given. It would certainly serve the ends of simplicity if only a single definition were used whenever it was decided to favor closely held business.

I would recommend that there be only a single test, namely, whether the business has outstanding any marketable securities. It is the lack of marketability and consequent lack of market value which justify a deduction for the investment, a postponement of the tax to the employee who receives the stock, a postponement of the estate tax on the stock. It should be noted that I would not make the test whether the particular security is marketable, because it would be too easy to devise non-marketable securities to obtain the tax benefit. If a business has outstanding any marketable securities, it has access to the capital markets and, therefore, has less need for help. Concepts similar to "marketable security" are used in various places in the Code and should not pose any particular difficulties. See IRC §453(b)(1)(3), IRC §1232(b)(2).

(9) Choice of Form. A small business may be organized as a subchapter S corporation, a regular corporation, a sole proprietorship or a partnership. Except for the fact that a partnership requires more than one investor, the business and economic aspects may be entirely identical, but the tax consequences vary widely. There are differences in the taxation of the business, the taxation of the owners on the profits of the business and the timing and nature of deduction for losses. There are differences in recapture of investment credit as a result of changes in ownership, there is a difference in the nature of permissible qualified plans and other fringe benefits, there is a difference in the tax treatment of the owner on disposition of his investment.

It is difficult to imagine what worthwhile policy is served by creating these differences. As stated above, Congress should decide on the tax treatment of investments and disinvestments, the taxation of income and loss, etc., in each case hopefully in such a manner as to support the formation and operation of small businesses and then make this treatment uniform, no matter what the particular form of the operation.

Differences in taxation based solely upon differences in form are so deeply ingrained in our tax system, that it may be pie-in-the-sky to talk about taxing small businesses in the same way just because their economic situation is identical. But my pie-in-the-sky would be "the Close Corporation".

The Close Corporation, like a partnership, would be a tax reporting but not a taxpaying entity. The taxpayers would be the owners. There would be graduated rates up to 50% on the <u>active business income</u> of the Close Corporation whether or not is "earned income". (I fail to see why used car salesman Jones who buys a car for $5,000 and sells it for $6,000 should be taxed differently from used car salesman Smith who engages in the same transaction but receives the $1,000 profit as a commission or salary).

The normal individual rates would apply to the net <u>passive income</u> of the business.

There would be a pass through of losses, exempt income and capital gains. As in the case of a partnership, there would be no tax on distributions. On a sale or redemption of stock above book value, there would be an automatic step-up in the basis of the Close Corporation's assets.

This approach would at one fell swoop eliminate many of the tax problems that bedevil owners of closely held corporations: Reasonable compensation, accumulated earnings tax, redemptions taxed as dividends, the complexities of the one-month liquidation, one-year liquidations and collapsible corporation rules. Further, the benefits of what are in fact although not under the law personal holding companies (as well as the complexities of personal holding companies) would be eliminated, because the system would not be elective: If a business qualified as a Close Corporation, it would be taxed as such.

If any earnings are not distributed, they would be treated as reinvested, so that within the limits proposed in the first recommendation above, there would be a deduction for the undistributed earnings.

Special attention would have to be paid to the tax rates applicable to active business income. At the present time, small business organized as a corporation enjoys substantial surtax exemptions up to $100,000 and a top tax rate of 46%. This provides a meaningful tax shelter for the accumulation of the capital that the small business needs. (It is the absence of this tax shelter in subchapter S, that makes this form generally unattractive).

The rates on Close Corporation profits should not reduce the present tax benefit. On the other hand, it is clear that the gross profit of small businesses is in substantial part distributed as salary, subject to individual rates. The following schedule shows what I believe to be a good guess as to the present situation, showing the combined corporate tax on the business and the individual's tax on salary. The Close Corporation tax rates should be structured to give substantially

63-769 O - 80 - 38

the same result. (In making the schedule, I have assumed a joint return, two exemptions and income from other sources equal to the owner's deductions.)

Gross Business Profit	Probable Salary of Owner	Net Business Profit	Tax on Salary	Tax on Net Business Profit	Total Tax	Tax as % of Gross Profit
10,000	10,000	-0-	702	-0-	702	7.02%
20,000	15,000	5,000	1,635	850	2,485	12.43%
50,000	35,000	15,000	7,348	2,550	9,898	19.80%
100,000	60,000	40,000	18,698	7,250	25,948	25.95%
150,000	90,000	60,000	33,678	12,250	45,928	30.62%
200,000	125,000	75,000	51,178	16,750	67,928	33.96%
300,000	150,000	150,000	63,678	49,750	113,428	37.81%
500,000	175,000	325,000	76,178	130,250	206,428	41.29%

I do not doubt that the approach here suggested would bring with it its own problems and complexities.*/ But there would be only one set of these, rather than the three that we have now. A very large part of all tax controversies involve plain error and ignorance on the part of the taxpayer or the tax adviser, error and ignorance arising from the complexities of the law. The resulting taxes are taxes on ignorance and incompetence rather than taxes based upon income. Eliminating

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*/ For instance, the Close Corporation, like the family partnership and subchapter S corporation, opens the door to tax avoidance by the assignment of earned income to other family members.

difference in tax based upon a difference in the form of organization is merely one aspect of simplification, but it is the most important.

> Note on Pending Legislation. S.2168 (96th Cong. 1st Sess.) would seek to achieve some of the results here proposed by liberalizing subchapter S. However, the differences between these approaches is substantial. I would provide the same treatment for all active business income, whether "earned" or not. Subchapter S now makes a distinction between business income withdrawn as a salary and business income withdrawn as a dividend. Subchapter S does not provide for pass through of all types of income, as a partnership now does and as the Close Corporation would. Changes in ownership of a subchapter S corporation trigger all kinds of tax consequences. In a partnership, usually a 50% change is required. The taxation of a Close Corporation would not be affected by changes in ownership, except to adjust basis. Altogether, subchapter S as it now is has proved to be cumbersome and complicated. Further, and perhaps most important, it does not provide the shelter of the corporate surtax exemption.

In closing, I would encourage Congress to provide a reasonable and fair tax system for closely-held business without worrying too much whether other taxpayers will get the same treatment or whether the symmetry of the tax law will be disrupted. A great part of the complexities of the tax law is due to insistence on formal symmetry. But, a father who loves his children equally and wants to treat them fairly does not necessarily give each the same present or send them to the same school. Surely, small business and those who own it should fairly contribute to the cost of running this country. But, whether a method of taxation is fair should be determined on an overall basis and not by comparing the treatment of specific transactions for different classes of taxpayers.

In a very general way, it may be said that what is here proposed would make small business taxes turn more or cash flow than accounting and legal concepts of income. But, it is cash that is needed to pay taxes and a law that gives due regard to the reduced ability to pay of growing small businesses and those who invest in them and taxes then when they can pay, may in the long run make for healthier business and greater taxes.

Sincerely,

Frederic G. Corneel

Frederic G. Corneel

FGC/mb

UNITED STATES SENATE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

FINANCE COMMITTEE

Supplemental Statement of Converse Murdoch, Esquire
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Hearings on Tax Policy for Small Businesses

April 1, 1980

Specific Comments on Bills
Which are the Subjects of the Hearing

This is a supplement to my statement. The purpose of the supplement is to set forth brief comments on the specific bills which are mentioned as subjects of the March 28 and April 1 hearings of the Subcommittee.

The staff of the Joint Committee on Taxation has prepared a very helpful booklet describing the various bills. In the balance of this statement, the Joint Committee description of the bills is referred to as "staff description."

S-110

Small Business Depreciation Reform Act

As indicated in the full statement, I give depreciation relief for small business a lower priority than corporate income tax rate reductions in the lower ranges of corporate income.

However, this particular bill providing for an elective three-year, straight line depreciation of up to $25,000 in annual acquisitions of property is certainly to be preferred over the more sweeping 10-5-3 depreciation proposals mentioned in the full statement and embodied in S-1435.

The revenue loss from S-110 is substantially less than that contemplated under S-1435. Accordingly, enactment of this bill rather than S-1435 would leave more tax reduction dollars available for other items which would benefit small businesses.

Also, placing a cap of $25,000 on the amount eligible for faster depreciation would tend to concentrate the relief in the small business area where it is most needed.

In its present form the bill has the beauty of relative simplicity. However, the staff summary suggests (staff summary, page 8) the need for modifications to meet some "relatively technical" issues. These include the need to have a controlled group rule and a related party rule to prevent avoidance of the dollar limitations. The staff summary at the same point mentions several other technical problems. While such polishing and buffing may seem to be desirable--that would certainly be a move away from simplicity and towards complexity. That does not mean that the move would be wrong. It does mean that this is another example of where complexities are being proposed in what would otherwise be a simple provision.

S-487

Small Business Private Investment Act

This bill would provide a tax credit for investment in certain small business companies' stock.

As indicated in the main statement, I believe that priority should be given in tax relief for small business to those proposals which would benefit small businesses attempting to make it on their own by accumulating capital out of earnings. This bill would concentrate relief in the hands of investors in small businesses rather than in the hands of active-participants who are owners of small businesses. In fact, any taxpayer who owns more than 80% of the voting stock of the small business would be denied the credit. The credit would only be available with respect to common or preferred stock registered under the Securities Exchange Act of 1934. This would effectively eliminate any benefit for most small businesses which are not required to be so registered and who are loath to incur the added legal and accounting costs associated with such registration. In essence, this bill would only give relief of a limited type to persons investing in what can fairly be described as publicly-owned companies. Such companies simply don't fit in my definition of small business for purposes of talking about tax relief for small business.

This bill also would result in piling on more complexities in the tax law.

S-653

Non-Recognition of Gain on the Sale of Certain Small Business Stock

This bill would permit tax-free rollovers of gains from sale of small business stock into investments in other small business stock.

This concept is discussed in the main statement and is given a low priority in terms of relief for small business. Again, this bill would focus relief on outside investors in businesses rather than giving relief to active participants in the business. Tax relief is more needed by small businesses which are forced to accumulate their own earnings in order to survive and who have little, if any, hope of making public offerings of securities.

The rules introduced by this bill would be difficult to police. The rules would require tracing of basis and notices to IRS of dispositions of interest.

S-1435

Capital Cost Recovery Act

This bill would provide for what is popularly referred to as the "10-5-3" capital recovery method. As indicated in the main statement, this sort of relief is not particularly helpful to small business. It would result in very substantial revenue losses. See staff summary, page 38.

It is submitted that most of this relief would go to capital intensive big businesses and little of the relief would be available to labor intensive small businesses.

Even the well-written staff summary descriptions of this bill is very complex. It is not difficult to imagine the complexities which will follow as the bill is considered further, as it is implemented by regulations and as rulings and court decisions emerge.

S-1481

Small Business Participating Debentures

This bill would grant an income tax credit and certain other favorable income tax breaks for investors in a new type of security to be known as a small business participating debenture.

I commend the innovative thinking behind this bill. Of all of the bills pointed towards relief for investors in small business (as contrasted with the small business itself), I think this one has the greatest promise.

Nonetheless, it concentrates relief at the passive investor level rather than at the level of the business itself or of the active participants in the business.

It is a very complicated bill.

The effect of the bill would be to encourage the issuance of securities which would in turn require distribution of earnings rather than having earnings plowed back into the business for further expansion. In today's climate it is most important to encourage small business to plow back earnings rather than to distribute them.

S-1967

Capital Formation Incentive Aid

This bill would permit a deferral of substantial amounts of income of brokers maintaining a market in certain securities of small businesses.

This bill focuses on a very narrow problem. All of its relief would go to stockbrokers rather than the small businesses. Moreover, the relief would only be available to brokers dealing in what amounts to publicly-owned companies rather than closely-held small businesses.

S-2136

Small Business Tax Reduction Act

I would rank this as the most needed of all of the bills subject to these hearings. As indicated in the principal statement, this bill promises the greatest relief for those small businesses most burdened by present tax rates, the credit crunch and inflation.

It is simple. In fact, it introduces absolutely no complexities into the law. The revenue losses indicated in the staff summary (at page 45) are surprisingly small.

If I had to come up with adverse criticisms of this bill, they would be based upon the failure of the bill to raise the level to which corporate tax graduation would reach and the failure to index the surtax exemption levels to the inflation rate.

S-2152

Used Machinery Investment Credit Adjustment Act

This bill would substantially increase the figure for annual purchases of used equipment eligible for the investment credit.

The bill would have a surprisingly large revenue impact. See staff summary, page 46. My preference would be to use some of the tax reduction indicated for this bill by increasing the reduction available by lowering corporate-income tax rates in the small business area.

My experience does not indicate a crying need for the relief furnished by this bill.

However, the bill does have the beauty of relative simplicit and I assume that it would concentrate much of its relief in the small business community where purchase of used equipment is more prevalent than in the large business community.

S-2168

Subchapter S Capital Formation Act

This bill would permit corporations with up to 100 shareholders and with more than one class of stock to elect Subchapter S treatment.

This bill would furnish practically no relief for small businesses hoping to grow by accumulating capital out of earnings. It is my observation that most small businesses, which are well advised, adopt Subchapter S status only during their very earliest periods when they anticipate losses which can be passed through to the stockholders for tax purposes. Once the corporations become profitable, they drop Subchapter S unless they have no need for capital and are in a position to currently distribute all or most of their earnings.

Accordingly, this bill would furnish little relief for the small businesses most in need of relief at the present time.

S-2171

Time for Furnishing Form W-2 to Terminate Employees

This bill touches a very small problem. It would relieve employers of the necessity of mid-year issuances of Forms W-2 (Statement of Wages and Tax Withholdings) for employees who are terminated during the year. The bill would permit an employee to request the early receipt of a Form W-2. However, in the absence of such request, the employer could furnish the terminated employee with a Form W-2 at the same time that like forms are furn ed to other employees.

This bill has everything to recommend it. It has no revenue effect. It is simple. It will reduce the paperwork and hassle burden on all employers--large and small.

I cannot think of a single argument against enactment of this bill.

S-2239

Incentive Stock Options

This bill would, in effect, restore old law about qualified and restricted employee stock options. Relief of this kind has a very low priority for most small businesses for the reasons indicated in the main statement.

Stock options are simply not a feasible or attractive employee incentive device in companies whose stock is not actively traded or readily marketable.

The only provision in this bill which has a small business impact is a provision which has an adverse effect on small businesses. The bill would require that a qualified stock option be granted at 100% of the value of the stock at the time the option is granted, but would impose a tougher rule in the case of an option granted to the owner of more than 10% of the value or voting power of the stock of the issuing company. This can only have the effect of discriminating against small businesses where ownership is not so widely held. That special rule has nothing to do with the wealth or power of the owner of 11% of a closely-held company as contrasted with the wealth or power of a person owning 10% or less of a large publicly-held company. For example, if an executive of the General Motors Corporation owned 10% of that company's outstanding common stock, he would have an asset valued at over $1,325,000,000--forgetting about any blockage discount. Even if one assumed a blockage discount, that executive's interest in the company would still be worth over $1,000,000,000.

On the other hand, if an individual owned 11% of the outstanding stock of a corporation holding a GM dealer's franchise and the dealership had a net worth of $200,000, the 11% shareholder would have an asset worth $22,000--before a 40-50% discount for the minority interest factor. Unless the holder of the 11% interest in the GM dealership had some family connection with the holder of the 89% interest--I seriously question whether he would have as much influence over the policies of the dealership corporation as would the mythical executive of the General Motors Corporation itself who held 10% of its outstanding stock. Under S-2239, the mythical General Motors executive would get a tax break through an option to buy General Motors stock at 100% of value whereas the holder of the 11% interest in the dealer corporation would have to be given an option to buy stock at 110% of the value of stock in his company. As if those disparities were not enough, the General Motors executive could rest assured that his option would be qualified, if intended as such, by virtue of the fact that during every business day there are quoted prices for trades in General Motors stock. On the other hand, the stock of the dealership probably changes hands once a generation and whatever value is placed upon the stock is almost certain to draw a challenge from an auditing revenue agent years after the grant of the option.

Respectfully submitted,

Con Murdoch

CONVERSE MURDOCH

Senator BYRD. Next will be a panel of small businessmen, Mr. Thomas E. Huntzinger, president, Huntzinger, Miller & Associates of Hanover, Pa., Mr. Sam Derieux, certified public accountant, Richmond, Va., Mr. Dean Treptow, president, Bank of Brown Deer, Brown Deer, Wis., and Mr. Dwane Perasall, president, Small Business Development Corp., Golden, Colo.

This is a well-diversified, geographically, at least, panel. Pennsylvania, Virginia, Wisconsin, and Colorado.

I like the name, Brown Deer.

Who wishes to proceed first?

We are missing one individual.

Mr. HUNTZINGER. Mr. Pearsall is not here.

Senator BYRD. Mr. Pearsall is not here.

Mr. HUNTZINGER. Since my name is first, I suppose I will start. Plus, with these distinguished panelists beside me, I certainly do not want to follow their act. So I think I will start.

Senator BYRD. Please proceed.

STATEMENT OF THOMAS E. HUNTZINGER, PRESIDENT, HUNTZINGER, MILLER & ASSOCIATES, HANOVER, PA.

Mr. HUNTZINGER. As a matter of very brief background I am a certified public accountant in a small town in south-central Pennsylvania. Our practice services approximately 150 small businesses and farmers, or including farmers, I should say.

I was a delegate moderator during the White House Conference on Small Business and much of what I am going to say will be as a result of my experiences related thereto.

Mr. Chairman, as you had stated earlier, the capital formation options that were contained in the White House Conference on Small Business were far and away the most significant and the most important as a result of the priority voting of all the delegates to that conference.

The involvement in the capital formation area was very intense and nearly overwhelming in that over half the delegates participated in the capital formation area and I feel very proud to have been a part of that.

What I want to relate to you is my view of what the focus was of these delegates and I will put it through my own eyes and my own words and my own experiences.

I will give you a brief overview and then get into where I really think the delegates want you to go.

No. 1, I feel that there was a great amount of frustration among the delegates and it comes about through the constant changes through the Internal Revenue Code. We seem to lurch from one economic crisis to another.

We have a 1974 act. We have a 1976 act. We have a 1977 act. We have a 1978 act. That is a lot of acts, but there is no action.

What I think the small business person is trying to tell you is, let's establish a long-term plan of action. Let's make the tax rates realistic. Let's make the Internal Revenue Code a little more simple. Let's make it more equal and let's get to work. Let's plug in our tax rates and our rate reductions over an extended period of time so that the Government and the business community can plan.

As a matter of just a little background also, the prior panel toward the end got into the area of revenue losses and also inherently the word "tax expenditure" I am sure will come up some time during the day today.

I want to make one thing very, very clear. No. 1, the term "revenue loss," while acknowledged as being real, revenue losses determined on a static basis are unacceptable to the small business community. If you say the reduction of the maximum tax and personal income taxes from 70 percent to 50 percent is going to cost x billions of dollars, we do not believe you.

We think it is x minus something.

As one of the delegates in my session on one of the 2 days of the conference said, what in the world do they think we are going to do with the money? Put it in a sock and bury it in the back yard?

We are in turn going to earn more revenue from it.

Senator CHAFEE. Well, I could not agree with you more. The trouble is we sit here in these sessions and the Treasury Department is very inflexible—not half as imaginative as you are.

Mr. HUNTZINGER. That is why I am here. I am here to tell you that there is another world out there, where the real world operates, and we know that you are going to hear one story from Treasury and frankly I am here to make sure you hear the other side of the story.

Treasury will always talk also in terms of tax expenditures. I just read an article yesterday about it. And every time I see the term tax expenditure, my blood boils. A tax expenditure——

Senator BYRD. If you would let me interrupt you at that point, I feel the same way.

Mr. HUNTZINGER. Thank you, Mr. Chairman. I am glad you agree.

Because the idea that it is a tax expenditure when I am allowed to keep what is already mine—that is just so totally unacceptable. So that when you on the Hill and Treasury deal in these terms, we frankly are not going to listen to you.

That was an overwhelming piece of sentiment that I am passing along to you.

Now, I think that, judging from the bills that were in the press release for some review, I would like to categorize those bills plus the options and try to mesh them together—the options that were contained in the White House Conference of Small Business final listing.

I think they can be categorized in three general areas. One would be capital formation purely. Those items, as Mr. Murdock mentioned earlier, that are of limited cost to the Treasury—cost in quotations, please.

Then there is an area of equalization of treatment of certain items and simplification. Again, the revenue losses, to use the Government terms, would probably not be all that significant.

Third, would be the area of capital retention as opposed to capital formation—retention dealing with reductions in tax rates, now very briefly on capital formation.

I think that if you took S. 1481, the small business participating debenture, and moved on it—here you are talking about an item that cannot cost that much money. We do not know a lot about it yet. Probably a lot of study has not been made on it in terms of the prospective use for it. But I will say this much: it came out of nowhere through the conference process. It is probably one of the most innovative pieces of potential legislation that is helpful to the small business community that has come along in a long period of time, and as long as it would be passed in a flexible form, it would be highly acceptable to the small business community.

Second in this particular area of capital formation would be the rollover bill, and this particular option as voted on an approved by the delegates to the Conference. The essence of it was that the tax on the gain of the sale of any capital asset should be deferred to the extent that it is reinvested in a small business.

There are many ways obviously to word a rollover provision. This is the one that is recommended by the small business community.

The tax credit portion of that particular option was not really the major thrust of it. The rollover was definitely the major thrust. But the tax credit is geared a little differently than the proposal that is on the list for this hearing, in that we do not think that the tax credit should be limited to listed securities.

That would benefit a very, very small percentage of small business. It should not be limited to listed securities.

The next area is that of equalization and simplification. The prior panel got into this somewhat in the terms of equalization. I am talking about the Keogh deduction for self-employed small business people.

You must understand and never lose sight of the fact that the overwhelming majority of the small business people are unincorporated, and wish to remain so. But they pay a price.

They can take a Keogh deduction for 15 percent of their first $50,000 in earnings, which is far, far different from what their counterpart would be as an incorporated individual.

They cannot deduct their personal group and health and accident insurance except on schedule A. They cannot take it as a business deduction. Only one form of disabiity insurance is deductible. Virtually no form of life insurance is deductible to a self-employed individual.

These inequities must be dealt with.

In terms of simplification, there are two key areas. I will not go into depreciation because that has been dealt with before on the earlier panels, and I am sure will be dealt with again, except to say that depreciation should be simplified. We need some form of capital cost recovery system to replace ADR.

What we also need is a simplified form of LIFO valuation of inventories. The Treasury has been studying this particular area for long about 2 years at least. It is about time they get off their duff and recommend it totally to the Congress and be passed. It is a simple act. It would be very, very simple to put in. All they would have to do yet, in my judgment, is come up with industry indexes, and they have got it, and I do not know what is holding it up, but it absolutely is necessary.

Capital retention: The No. 1 option voted on by 88 percent of the delegates to the White House Conference on Small Business was the tax cut option. It starts out by saying that the maximum limit for the corporate surtax exemption should be raised to $500,000. I propose increasing that surtax exemption to $500,000 over the next 10 years. Start out by $150,000 that is before you and start increasing it into law over the next 10 years.

My prepared text, which is part of the record, indicates the particular schedule that I recommend for that, and I think the individual rate brackets should be adjusted accordingly.

This would be part of the long-term tax planning that the Congress could affect and it would assist in the individual and corporate tax planning of the small businesses in this country.

And I would underscore that over 90 percent of the corporate tax returns filed are filed by small businesses, so let's not hear it from the Ralph Nader's and whoever that corporations got another break. You are darn right corporations did, but 90 percent of them were the little guy. It is about time that the Nation becomes a little more educated on who corporate America really is. It is we, the little guy.

Individual tax cuts: It is also important that you understand that option No. 1, as voted on by the delegates, was voted on with the wording that there should be a reduction in the maximum tax on individuals from 70 to 50 percent. That is absolutely the way it was voted on. It was not in the press releases.

The Commission's report, I believe, is to be released tomorrow, and I am sure—or I am at least hopeful—that that wording is in the final report, because if it is not, there is going to be an absolute storm come out of the delegates to the White House Conference.

Senator BYRD. Why was it not in the original report?

Mr. HUNTZINGER. There were efforts made to keep the wording to a minimum so as to not clutter up the ballot, which was going to contain 60 options. We in the capital formation area made every attempt to keep the wording to a minimum. There was a last minute rush and that wording simply did not get into it.

However, as my colleague, Mr. Treptow, can verify, he is the one who stood before the entire delegation and said that this option includes the wording, "Reduction of the maximum rate from 70 to 50 percent."

So the hundreds of delegates who voted heard Dean Treptow. I heard him loud and clear, and I applauded.

Now, there are several reasons for this. No 1, as a practitioner I can tell you that as the tax brackets exceed 50 percent and the effective rate of an individual's tax approaches 50 percent, he slacks off. Now, almost by definition, the people who get into these brackets are your more innovative and aggressive people.

Now, when you have a regressive tax system that no longer rewards them, when you have a tax system that says we are going to take 54 percent, 62 percent, 64 percent, 70 percent of your taxes as you go up, they are saying hey, equal partners is fine, but beyond that, forget it. I am going to take a vacation. I am going to go up to the beautiful lakes of Wisconsin and visit Dean Treptow.

I am not going to bother to make more money this summer. Why bother? Uncle Sam is going to get 60 cents on the dollar. It is absolutely regressive, and it is actually rather amusing also in computing the maximum tax on earned income, which I get into this time of the year, that we have a computation whereby to the extent that a sole proprietor or a partner's income represents a return on capital, he is subject to rates of 70 percent.

Now, we are here talking about capital formation and we to tax it by law, by code, up to 70 percent? We think that is ludicrous, absolutely ludicrous. We think that is not wishful thinking, to reduce individual income taxes and corporate income taxes. It is not a wish list. It is something we feel is realistic and this Congress, or future Congresses, have better deal with quickly, or we are all in trouble.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir.

Mr. Sam Derieux? I am glad to welcome my friend from Richmond, Va.

Mr. DERIEUX. Thank you, sir. It is nice to be here with you.

STATEMENT OF SAM DERIEUX, CPA, RICHMOND, VA.

Mr. DERIEUX. My purpose this morning is to report on the Homestead Small Business Tax Conference which took place last week.

Senator BYRD. Excuse me, to what are you referring when you mention Homestead?

Mr. DERIEUX. That is the location, yes, sir.

This was organized by the American Bar Association, their small business committee of one of the sections of the bar. I am not a lawyer, but was privileged to be there to join with lawyers, with other accountants, academics.

Senator BYRD. Is it Hot Springs, Va.?

Mr. DERIEUX. Yes, sir.

There were approximately 70 participants in that conference. We, at the beginning of the conference, recognized that the term small business includes not only privately held enterprises, but also some smaller, publicly held companies. Some of the recommendations that came out of the conference would help one of those groups more than the other, but we did have both of them in mind.

I would like to go directly into the recommendations of this conference.

One had to do with employee benefits and included a recommendation that there be available small business stock options. This might be of more use to the smaller publicly held companies but contrary to what one of the earlier witnesses said, I believe that it would be of interest to many privately held companies as well.

We recommended that where there are small business tax options that no income be realized by the recipient until a sale of that stock, until he actually realized income or cash, and then he would have long-term capital gain treatment, provided the stock had been held for 12 months and there was at least 3 years from the date of the grant of the option.

And this should be available to any employee, including owners, but if there were a limit on ownership, we would recommend that it not be higher than 25 percent.

The conference also recommends a stock ownership plan which would make stock available to employees for some consideration which might be less than fair market value.

Again, we recommend that there be no tax until ultimate realization, ultimate sale, but if there is a difference between the exercise price and the fair market value at the date of grant that that would be treated as ordinary income and the appreciation would be treated as long-term capital gain?

Senator CHAFEE. Could I ask a question right here, if I might, Mr. Chairman, I am mixed up on what you are—on you on S. 2239 and is that the same measure that Mr. Huntzinger threw cold water on?

Mr. DERIEUX. I am not referring to a specific bill that is before you.

Senator CHAFEE. But you are taking a different view than Mr. Huntzinger?

Mr. DERIEUX. Yes.

Senator CHAFEE. It seemed to me that he put little stock—I should not use the word stock—he ascribed little merit to a proposal that involved stock options.

Mr. DERIEUX. Yes, he did.

Senator CHAFEE. But you are taking an opposite view?

Mr. DERIEUX. Yes.

Senator CHAFEE. What do you do with the valuation problem that Mr. Huntzinger discussed?

Mr. DERIEUX. Well, the conference addressed that and recommends that if the option price is at least as high as book value that that would be presumptive of fair market value. This would avoid many controversies with the Internal Revenue Service about what fair market value is.

Senator CHAFEE. Do you think we have got a problem here in a lot of redtape and so forth to arrive at a value? I suppose book value is not hard to arrive at.

Mr. DERIEUX. Book value is easy to arrive at, and if there is a presumption that in the absence of trading of the stock that that would be fair market value, then we do eliminate a lot of the redtape and a lot of the controversy.

Senator CHAFEE. It seems to me that we have to assume there is no market value in these small businesses.

Mr. DERIEUX. If you would bear in mind that we were talking about two kinds of small business, one of which is a smaller, publicly-traded company. Those companies also have difficulty in obtaining and retaining capital.

Senator CHAFEE. Do you mean over the counter, or something like that?

Mr. DERIEUX. Yes, sir.

This proposal might be of more value to the smaller, over-the-counter companies, but in my opinion it ought to be available to the privately-held companies as a means of getting employees involved in the company, letting them have a piece of the action, so to speak, and for planning for the continuation of the company when the founder wants to retire.

Senator CHAFEE. Thank you.

Senator BYRD. Mr. Derieux, if I may interrupt you just a moment, Senator Nelson has another very important meeting that he must attend and I want to recognize him in a moment.

First, I want to say that he is Chairman of the Task Force on Small Business which was recently appointed by the majority leader of the Senate and has taken a tremendous interest in the problems of small business. He played an important role in developing these hearings which we have been holding over a few days, and we will have some more hearings in the future on the question of small business.

Senator Nelson?

Senator NELSON. Thank you, Senator Byrd. I was late in getting here because I was meeting with the Wisconsin Farm Bureau. There is also a hearing in the Human Resources Committee which I must attend. Consequently, I just wanted to be here long enough to introduce Mr. Dean Treptow, who is president of the Brown Deer Bank in Brown Deer, Wis. He is here today to testify on behalf of the Independent Business Association of Wisconsin.

Mr. Treptow is in a unique position to understand the concerns of small independent businesses. He served as chairman of Wisconsin's delegation to the White House Conference on Small Business, he is president of the Independent Business Association of Wisconsin and president of an independent banking institution.

So Mr. Treptow has firsthand knowledge and experience of many of the economic difficulties of independent businesses and I am delighted to be here to welcome Mr. Treptow before the committee.

I would ask that my statement be printed in full in the record, and I extent my apologies to Dean for having to run over to the Human Resources Committee.

If an emergency arises, I shall return.

Senator BYRD. We will send for you, Senator Nelson.

Senator NELSON. Thank you very much.

[The statement of Senator Gaylord Nelson follows:]

STATEMENT OF SENATOR GAYLORD NELSON

Mr. Chairman, this morning the Subcommittee on Taxation & Debt Management concludes two days of hearings on the number one problem facing small business—capital formation. The study of this problem began some five years ago under the auspices of the Senate Select Committee on Small Business. As Chairman of that Committee I initiated a series of hearings beginning in 1975. Significant legislative proposals were developed based on the information and data gathered at those hearings. Many of these proposals have already been enacted into law. Among them, a substantial reform of the federal estate and gift tax laws affecting the inheritance of farms and small businesses; an increase in the amount of used machinery and equipment eligible for the 10 percent investment tax credit from $50,000 to $100,000; an increase in the corporate surtax exemption from $25,000 to $100,000; and enactment of the most extensive graduated tax rate structure since the inception of the federal corporate tax in 1909.

These changes have had a significant impact on easing the capital formation problems of small business. But much more needs to be done if our nation's innovative and independent business community is to grow and expand and provide more jobs and increased productivity. Indeed, in the present economic climate, much more needs to be done to insure the very survival of these businesses.

An inflation rate running at better than 18 percent, interest rates on borrowed funds in excess of 19 percent, declining productivity, burdensome government regulation and unnecessary redtape, and a shrinking marketplace have all combined to place an enormous burden on the average small businessman.

Double digit inflation means that it costs twice as much today to replace equipment and machinery purchased 7 to 10 years ago. This, coupled with the diminishing purchasing power of the dollar, places the small independent entrepreneur in a precarious economic position. He cannot afford to replace worn out plant and equipment. Without modern and up-to-date machinery, his business's productivity often declines, sales drop off and jobs disappear. The result is he either goes out-of-business or is forced to borrow heavily in order to survive. But with today's high interest rates, this alternative is extremely prohibitive. Many small businesses which purchase and maintain their inventories with borrowed funds are on the verge of financial disaster. Unless interest rates come down or inflation subsides, these businesses will be forced to liquidate their inventories at substantial losses.

Earlier this year the first White House Conference on Small Business was held. This conference focused not only on the capital formation requirements of small business but on such diverse problems as regulatory reform, patent policy, inflation, innovation and the development of a small business export policy. The delegates to the conference came from every state in the nation. From this conference came forth a series of legislative recommendations. Many of the proposals are currently embodied in bills introduced by members of this Committee. Fifteen recommendations were made in the area of capital formation.

Today's hearing will focus on these proposals. They include:

S. 653, a measure which would allow taxpayers to defer the capital gains tax on the sale of an interest in a qualifying small business, provided the proceeds from the sale are reinvested in another small business within 18 months from the date of sale.

S. 487, a proposal which would provide a new investment tax credit equal to 10 percent of the first $10,000 and 5 percent of the next $40,000 invested in a small business, for a maximum credit of $3,000.

S. 2136, a proposal to increase the corporate surtax exemption from $100,000 to $150,000.

S. 2168, a bill to increase the permissable number of Subchapter S shareholders from 15 to 100, and

S. 2152, a measure which would increase the amount of used equipment eligible for the general investment tax credit from $100,000 to $200,000.

All of these proposals were recommended by the White House Conference on Small Business. Each of them represents a priority of a majority of the delegates to the Conference. Taken together, they represent an attempt to inject new capital into the nation's cash starved small businesses.

We are pleased to have with us today two witnesses who are well acquainted with the capital formation problems confronting small business.

Mr. Dean Treptow who is the President of the Brown Deer Bank in Brown Deer, Wisconsin is here today testifying on behalf of the Independent Business Association of Wisconsin (IBAW). Mr. Treptow is in a unique position to understand the concerns of the nation's small business community. He served as Chairman of Wisconsin's delegation to the White House Conference on Small Business and as President of IBAW and a small independent banking institution, Mr. Treptow has first-hand knowledge of the many economic difficulties of independent businesses.

Mr. Samuel Derieux is Chairman of the American Institute of Certified Public Accountants' Committee on Small and Medium-Sized Firms. he is also past President and Chairman of the Board of the American Institute of CPAs. This past week Mr. Derieux attended the Small Business Homestead Tax Conference in Hot Springs, Virginia sponsored by the American Bar Association. Attorneys, economists, accountants, congressional staff, academics and small businessmen from around the country participated in three days of intensive meetings to consider and develop a series of proposals for improving the federal tax system and encouraging capital formation for small business. Mr. Derieux is here today to report on the results of that Conference.

I look forward to reviewing the testimony of these distinguished gentlemen and the expert witnesses on today's panel.

S. 2480—Increase in Minimum Accumulated Earnings Credit

PRESENT LAW

In addition to the regular corporate income tax, present law imposes an accumulated earnings tax of 27½ percent to 38½ percent on improperly accumulated corporate earnings where the accumulation occurs in an attempt to avoid the individual income tax. In computing the base on which this tax is imposed, there is excluded an amount equal to the earnings and profits of the taxable year which are retained for the reasonable needs of the business. This is known as the accumulated earnings credit. Present law provides a minimum credit of $150,000 of earnings which may be accumulated before any accumulated earnings are subject to this tax. This is a cumulative credit rather than an annual credit. Thus, if more than $150,000 of earnings is accumulated, the accumulated earnings are subject to the "reasonable needs of the business" standard.

The minimum accumulated earnings credit was increased from $60,000 to $100,000 in 1958. It was increased from $100,000 to its present level of $150,000 in 1975.

ISSUE

The issue is whether the minimum accumulated earnings credit should be increased from $150,000 to $250,000.

DESCRIPTION OF BILL

The bill would increase the minimum accumulated earnings credit from $150,000 to $250,000.

EFFECTIVE DATE

The bill would apply to taxable years beginning after December 31, 1980.

REVENUE EFFECT

The revenue loss of this bill depends on the amount of corporate earnings that would be distributed to shareholders under the present law but would be retained by corporations if this bill becomes law. Because the staff does not know how many corporations would elect to increase their retained earnings as a result of this bill and when these corporations would do it, no revenue estimate has been prepared.

However, the potential revenue effect could be substantial because for each corporation that increases its retained earnings by $100,000, the revenue loss is about $40,000.

Senator CHAFEE. Are you intimately familiar with Brown Deer, Wis.?

Senator NELSON. Yes, and I might say that if you look at the blue book which keeps a record of election returns, you would do better there than I did.

Senator BYRD. We will get to you in a moment, Mr. Treptow. Mr. Derieux?

STATEMENT OF SAM DERIEUX—Resumed

Mr. DERIEUX. Another topic addressed by this conference was the capital gains rollover. This was endorsed by the participants in the conference who recommend a deferral of the capital gain of the sale of an interest in one small business if it is reinvested in another small business within 24 months after that sale.

The conference recommended that there be an unlimited number of such deferrals so that an individual entrepreneur might start any number of small businesses and take the proceeds and reinvest them in another small business.

The conference also recommended that a retiree rollover be made available. This would be available on a one-time basis to an individual 55 years of age or older who sells out of a small business and reinvests it in any other business, the idea here being that it would encourage investment in small business if the individual knew that he had a way to liquidate his interest without having to pay the capital gains tax and could reinvest it for his retirement.

Senator CHAFEE. Well, I must say, that does have attraction, does it not?

Mr. DERIEUX. Yes.

Senator CHAFEE. You put your money in a small business and you reach the age of 55 and then you sell out and instead of taking a whopping capital gain you just put your money into some listed security with no tax?

Mr. DERIEUX. With no tax at that point, yes. If you were to sell the listed securities, of course, you would then recognize gain.

Senator BYRD. That may be going a little far.

Senator CHAFEE. I was shocked at that myself until my staff informed me that I put in a bill just like it.

Mr. DERIEUX. The next point I was going to make is that the participants in the conference did recommend that there be a ceiling on the amount which could be so treated.

Senator CHAFEE. I think that would be nice. What is the ceiling?

Mr. DERIEUX. We did not come up with a number. We would leave that to your good judgment.

But we did heartily endorse the idea of the capital gains rollover.

The conference also endorsed the small business participating debenture, which it chose to call the small business participating security because it was felt that this should not be limited simply to debt securities, but also should include debt securities which might be convertible into equity at some later date.

This type of participating security would have a fixed interest rate which would be negotiated and beyond that would have a contingent interest which might be based on profits, it might be based on sales volume or some other factor within the business.

This we believe would encourage investment in small business and we believe also that this should be accompanied by an investment tax credit so that the money invested in one of these small business participating securities would produce a credit similar to the investment tax credit on fixed assets and would have the same rates and would have to be held for the same number of years as fixed assets.

We recommended that section 1244 treatment should be available if there should be a loss on the disposition of one of these securities, so that it would be deductible as an ordinary loss.

Another subject discussed at the conference was inflation and its effect on small businesses. The conference rejected the idea of automatic indexing for the very reasons that both of you gentlemen mentioned, but believed very strongly that inflation should be taken into consideration in adjusting some of the dollar limits which are now included in the Internal Revenue Code.

For example, the conference recommended that corporate tax rates go up to $150,000 before the full 46-percent rate would apply and the recommendations were for the first $25,000, 15 percent; $25,000 to $50,000, 20 percent; $50,000 to $100,000, 30 percent; $100,000 to $150,000, 40 percent; and all above that 46 percent.

The conference recommended that the accumulated earnings credit be increased to $250,000; that the limit on section 1244, ordinary losses, be increased to $100,000 or $200,000 on a joint return; and that the gift tax exclusion, which I believe has never been increased since it was first introduced in the late 1930's, be increased to $12,000 or $24,000 for a joint gift.

We further endorsed, as you did, a simplified LIFO—last in, first out—accounting method. Statistics indicate that many large corporations take advantage of the LIFO option but that very few small corporations do, primarily because of the added cost and the complexity of LIFO computations.

We also recommended that a simplified and more rapid cost recovery for depreciable assets. The conference did not endorse any specific bill that is before the Congress at this time, but the concept certainly was enthusiastically endorsed.

We took up the topic of innovation and barriers to innovation so far as small businesses are concerned and believed that there should be a further reduction in the capital gains tax, that subchapter S corporation treatment should be available to corporations having up to 100 shareholders and that the shareholders might include other corporations, trusts and partnerships.

We recommend a net operating loss carryover for an unlimited period of time. This would be particularly helpful to the new business which might experience a number of years of losses and should have a longer period of time, we think—an unlimited period of time—in order to recover those before having to pay tax.

Patent holders are obviously inventive, entrepreneural type people and we think the patent holder which is covered under section 1235, I think for individuals only, should be available to corporate patent holders as well. This would enable them to sell a patent right at long-term capital gain rates even though they received income based on a royalty or percentage.

Also that the transfer of patents subject to long-term capital gains treatment should be available to someone who sells geographic or field of interest rights in the patents. This is particularly helpful to the small businessman who cannot develop and market his product. He might want to sell the rights west of the Mississippi to somebody else, but continue to develop and market it himself, at another location.

We also endorsed the reserve for market makers, which is in Senate bill 1967. This applies to broker-dealers in securities who trade in over-the-counter stocks.

We believe that that bill should be extended to noncorporate broker-dealers. At the moment, it covers only corporate broker-dealers. We believe that the securities should include convertible, as well as equity securities, and that one more feature should be added.

At present, my reading of the bill indicates that once a reserve is established, if the broker-dealer ceased his market making activities, he would not have to be taxed on that reserve except over a period of years. We think he should be encouraged to continue his market making activities and therefore, the reserve should become taxable if he terminates the market making activities which gave rise to the reserve in the first place.

The conference did study the value-added tax. I think it is a fair assessment that the participants in the conference exhibited no great enthusiasm for the value-added tax, but probably saw it as something which may be inevitable and determined that if we are going to have a value-added tax that it should have certain features.

One of those would be that there should be some assurance of permanent reductions in other taxes, specifically income taxes. By a narrow majority, the participants in the conference voted that there should be some relief in payroll taxes. We voted that there should be a flat rate with no exceptions or exemptions, and if this works a hardship on any particular segment of the population, that should be addressed in some other way, and that the VAT should be stated on the invoice so that the purchaser would know how much value-added tax was being paid.

Mr. Chairman, I appreciate the opportunity of being with you this morning and presenting the views that came out of this conference.

Thank you, sir.

Mr. Treptow?

STATEMENT OF DEAN TREPTOW, PRESIDENT, BANK OF BROWN DEER, BROWN DEER, WIS.

Mr. TREPTOW. Brown Deer has its roots in small business. It started as a saloon and horse-watering spot on the stage coach run from Milwaukee to Green Bay. It was the first stop about 10 miles north of the center of Milwaukee.

So it was, in fact, founded with small business.

The local historians have no recollection whatsoever as to how the name arose and it remains a mystery today. So I cannot answer that queston.

Senator CHAFEE. Are you a suburb now of Milwaukee?

Mr. TREPTOW. Yes. The city of Milwaukee is now our west and south boundary and there are other suburbs to the north of us as well, so we are an intermediate-layer suburb within the Metropolitan Milwaukee area.

Senator CHAFEE. So you have a commuting population?

Mr. TREPTOW. Yes. The population of Brown Deer developed after World War II and then again a surge after the Korean war largely with veterans' single-family housing and the village developed quite an industrial park for small businesses. It was an early model for industrial park development for small business.

Our bank operates throughout the Metropolitan Milwaukee area meeting the needs of small and medium-size businesses, so that is the context in which I operate as a banker.

I would like to mention that Mr. Huntzinger and I were both active in the capital formation sessions of the White House Conference and as Senator Byrd said in his opening remarks, it is interesting that five recommendations for tax reform and also a directive to balance the Federal budget by fiscal 1981 and also restricting the size of that budget to a percentage of GNP ranked amongst the top 10 recommendations of that conference, and all delegates participated in that vote.

Senator BYRD. I think that is highly significant.

Mr. TREPTOW. It is extremely significant.

Senator BYRD. It is number three, I believe, on your list of priorities.

Mr. TREPTOW. Exactly right.

As a matter of fact, it received 62 percent of the votes of the total delegates, the balancing the budget feature did.

Senator CHAFEE. Did you have a percentage of GNP?

Mr. TREPTOW. Yes. It was tied to, I believe, 20 percent in 1981 declining to 15 percent, so it was specific.

I would also like to endorse at the beginning of my remarks what Mr. Huntzinger said about the recommendation included in those capital formation recommendations to cut personal taxes.

What really happened in this regard is that we ran afoul of the bureaucracy one more time. We discovered at the end of the second day of workshop sessions that the prepared ballot did not in fact include that provision which had been very forcefully put forth by the delegates and in trying to get it on the ballot at the last minute we were told simply—and I argued to some of the staff on this—simply that the ballots had already been distributed to the press and we could not change it at the last minute.

I was given assurances by the conference staff that it would be in the final recommendations and to assure that I did exactly what Mr. Huntzinger said, addressing the total delegate group, all of the delegates, in the closing plenary session I made that announcement that it should be, and would be, placed within the graduated corporate income tax option No. 1.

Senator BYRD. Did the White House appoint the staff, or did the Commission appoint the staff?

Mr. TREPTOW. The staff that operated the conference was largely appointed by the White House.

We were pleased to work with Senator Nelson in Wisconsin in, I think, setting the format for the actual White House Conference. We had had many people from our Independent Business Association of Wisconsin going to different parts of the country viewing other public forums that were being held.

Wisconsin's forum was the 47th forum to be held.

We learned one thing from the experience of other States and that was that there was a great deal of governmental input and control in these State forums. We appealed to Senator Nelson well in advance of a year of the White House Conference and asked him if he could contact the White House and obtain for us delegated authority to establish a steering committee of representatives of small business in Wisconsin to operate that conference, our Wisconsin forum for election of delegates.

He did obtain that authority for us and delegates did operate the Wisconsin forum and I think it set a precedent that became a very popular idea throughout the country and when the actual White House Conference came around in January, all of the sessions and workshop sessions were, in fact, moderated by small business people and I had the pleasure of being the principal moderator in charge of the capital formation session and worked with people like Mr. Huntzinger here, and I think it is significant to know that there were 24 individual workshops on capital formation.

In other words, 24 groups of small businesspeople who did not commingle with each other discussing these issues over a 2-day period. And their instructions were to come up with 5 recommendations from each of those 24 workshops and then we would pool them all and then try to reduce them to 5 top priority recommendations for all of the capital formation sessions.

When we met with those workshop sessions on the evening of the second day of the conference, I was absolutely amazed to find that 8 recommendations covered the top 5 from all 24 sessions. There were really only eight different recommendations, which I think showed a great unanimity of thinking of these people who came independently from all over the country and arrived at essentially the same conclusions.

I think there is a powerful message in that, also.

It is my judgment, however, that there is a potential for conflict, and at least I have heard here on the Hill that there is great concern about the conflict, but the fact that these tax-cutting measures for small business come out in the same time that we ask for a cut in the Federal budget, balancing it, limiting it to a percentage of GNP and balancing that budget.

I do not think there really needs to be a conflict, however. First, you should recognize that the delegates at this conference worked with the perspective of developing policy for their next decade. The capital formation recommendations were developed within that context.

In the area of balancing the budget and restricting its size to a percentage of GNP, however, they did specifically put a timeframe on it: balance it by 1981 and restrict its level to 20 percent of GNP.

I think that indicates the sense of urgency that these delegates felt for balancing the budget.

That sense of urgency came out of the great concern with inflation and the need to do something immediately with inflation and they deemed the balancing of the budget to be the most dramatic, important single thing that could be done to curtail inflation.

I think it was the opinion of most delegates and it certainly is the opinion of our Independent Business Association of Wisconsin, and most of my bank customers, that unless we can stop inflation, all the rest of these recommendations may very well be academic.

Interest rates are a very great concern to all of us. About a year ago, 6 months ago, I was concerned whether my bank would have the funds to meet the loan demands of my business customers. That concern, in fact, is academic now with present interest rates. The prime rate at 19.5 percent, it is a matter of how many people can really afford to use the funds at those interest rates.

Within my own bank, we had about a year and a half ago $20 million in regular passbook savings accounts paying an interest of 5¼ percent. Over $6 million of those funds flowed into the money market CD's now paying in the neighborhood of 15 percent and all of the new deposit growth, the net deposit growth in our bank, has been in the money market CD's at the present high rates, tied to the 6-month Treasury bills in the neighborhood of 15 percent.

So this cost escalation in money rates has just been tremendous.

I think these examples clearly reveal the order of priority for small business. It should not be construed, however, that small business is really complacent about the capital formation issues.

A balanced budget is just the focal point on which I think we need to start. And once we do something about this, small business would like to have commitment for doing what is necessary to refurbish and replenish the capital supply that they so desperately need in their business.

I would like to give you a little example, just a simple case history of a typical manufacturer and what has happened since the 1978 Tax Reform Act. That act graduated corporate income taxes for small businesses, graduating the rates up to $100,000.

It reduced the top rate for all corporate income from 48 percent to 46 percent.

Let's take the example of a manufacturer who had $3 million in sales in 1978. Now, let's further assume that that manufacturer sold exactly the same number of units in 1979 as in 1978 however, inflation increased costs and the manufacturer was able to increase prices by 15-percent. And that is probably fairly representative for 1979.

That means that sales volume in 1979 increased to $3,450,000 from $3 million the year before, yet the same number of units were sold. There was no real increase.

Now, let's assume that in both of these years the company collected its accounts receivable at an average of 45 days from the date of billing and maintained inventories equal to about 90 days of operation.

Very typical for small manufacturers.

The 15-percent inflation would result in an increase in his accounts receivable from $370,000 to $425,000. Inventories would have increased from $518,000 to $596,000. This represents an increased need for working capital of $133,000.

The company borrowed that money from the bank at an average cost of 15 percent. The interest expense would have been $20,000 or over twice the tax savings resulting from the 1978 Tax Reform Act.

You can readily extrapolate the effect of current conditions with inflation close to 20 percent annualized rate, and a prime rate now at 19.5 percent. The effect will be far worse.

I think it is appropriate to ask, however, how did the Government fare in an example such as this?

Now, if we assume that the corporate income prior to interest expenses in taxes in both years was 10 percent of sales, which is a pretty healthy number for a small manufacturer, then taxes in 1978 would have been $130,500. In 1979, applying the reduced income tax rates resulting from the graduation of taxes, the company's Federal income tax bill would have been $130,250. The Government, thanks to inflation, recovered all but $250 of a tax cut that should have been $11,900 in constant dollars.

Thanks to inflation, there was no capital formation for this type of company in the 1978 Tax Reform Act.

We can carry this example even further.

Banks lend money on their ability to repay. During 1979, this company was required to borrow at $133,000 in order to manufacture and sell the same number of units as it had done the year before and after paying its interest bill, the net income after taxes increased by $25,000.

If inflation remained at the same 15 percent rate in the future, the company would be running further in debt at the rate of over $100,000 per year. This obviously is a road to bankruptcy and I think you will agree with me that no bank would prudently lend into a situation like that over a long time period.

So what does the company do? It can try to cutback its accounts receivable, it can pare back its inventories, and when it has done the absolute best job that it is capable of doing, then the rate of borrowing and the rate of working capital increases continue to go right back up again, in accordance with the rate of inflation.

The profitability of small businesses cannot keep pace with this rate of inflation and the result is undoubtedly going to be tragedy for the small business sector.

What is small business to do in a circumstance like this? All he can do in the end is try to increase prices faster than the rate of inflation and that, of course, we all know is self-defeating because then small business becomes part of the problem even if it cannot control the prices that it is charging its customers at that rate.

Obviously there is no use in talking in circumstances like this, or an environment like this, about the ability of that company to fund applied research to significant product improvement. That company would not dare ask a lender for $100,000 to purchase a new machine tool, even if that investment could greatly enhance productivity.

Perhaps all he can do is sell out to a conglomerate with enough market control to pass through those costs to the consumer.

Now, Senator Gaylord Nelson has stated many times that everyone on Capitol Hill respects the importance of small business to our country. I am absolutely convinced this is true.

I do not believe, however, that many people are convinced of the desperate urgency for improvement of capital formation and retention for small business.

The recommendations of the White House panel that my two associates have addressed so well this morning, I think, address these needs extremely well.

America's small business people believe we must all make the necessary sacrifices and eliminate deficit spending for the 1981 budget. That action could be the beginning of a new economic era if it is followed with a tax policy that encourages savings and investment in this country.

Senator BYRD. Thank you.

I want to make a few observations and then yield to Senator Chafee and then to Senator Baucus.

I want to try to help small business. I want to support some, as many of their proposals as I can.

I think that some go too far, however.

Mr. Derieux, you mentioned the gift tax.

Mr. DERIEUX. Yes.

Senator BYRD. I think there should be a change in that. The present $3,000 exemption goes back to 1942. I think it is totally out of date now.

Your group recommended taking the exemption to $12,000 or $24,000 for a man and wife. Is that right?

Mr. DERIEUX. Yes, sir. That is correct.

Senator BYRD. Now, it seems to me that would—at least, that goes farther than I think I would be willing to go. I think that there should be a change. If you took it from $3,000 to $6,000, making it a total of $12,000 for man and wife, it seems to me that would be reasonable. I am doubtful about the $24,000, however.

Mr. DERIEUX. Well, of course, that would be an improvement, obviously. This figure was not found in the air, somewhere. This is the approximate effect of the change in the value of the dollar since the $3,000 was first established. That is where the figure came from.

Senator BYRD. Yes.

Then you mentioned the value added tax. No. 1, I would think that that is pretty far down the road. I do not see enactment of that anytime soon.

One thing I would fear about enacting the value added tax is that it would be put on top of all the other taxes. Now, if that is done I would think it would be totally undesirable.

Mr. DERIEUX. Absolutely.

Senator BYRD. It may have some merit if it is to take the place of other taxes, but certainly not to add it to other taxes.

Mr. DERIEUX. Yes, sir.

Senator BYRD. Let me ask you this. To what extent are small businesses merging with large corporations?

Mr. DERIEUX. In my experience, to a very large extent, Senator, and it has always seemed to me that one of the options that ought to be available to a small business is to remain a small, privately-held business if it chooses to do so.

Senator BYRD. Well, do you feel that there are incentives now, and what are the incentives?

Mr. DERIEUX. To merge?

Senator BYRD. To merge.

Mr. DERIEUX. One of them is the lack of liquidity. Sometimes the founder of a business or his descendants have estate tax liquidity problems that they can solve only by selling out. And although this was not a subject of the conference that I am reporting on, it seems to me that there ought to be perhaps some limited availability of a partial redemption of stock during that entrepreneur's lifetime so that he can diversify, to some extent, without the penalties of having to pay up to 70 percent on any money he withdraws from the corporation.

Senator BYRD. This committee held hearings last week, the 24th, I believe it was, on estate taxes. I think revision in the estate tax was one of the recommendations of the White House Conference on Small Business.

The best I can judge is that the estate taxes not only encourage but, in many cases, force the sale to large companies.

Mr. DERIEUX. Yes, indeed. That is a very, very severe factor.

Senator BYRD. I think that is the wrong direction to go in. We want to have more businesses, not less. I do not like the mergers of big companies with other big companies and I do not like the forced mergers of small companies with large companies.

Mr. DERIEUX. I agree and my experience in the accounting practice is that more and more small companies for the very reasons you described feel that they really have no other option but to sell out.

Mr. TREPTOW. Senator Byrd, could I make one remark about the mergers and concentrations?

In my prepared testimony, I included some remarks about some specific issues that I think bear on that.

There is a tendency for available capital in this country to be concentrated every time we reach a highly inflationary period in the economic cycle when money becomes tight. This situation is more aggravated at the current time than I believe it has ever been before.

There are, for example, some new instruments that are available for investment in this country, such as the money market mutual funds.

What has happened in this area is that we have the money market mutual funds and the U.S. Government at the present time aggressively competing throughout this country, even in the small towns throughout the Nation, even in the rural areas, attracting funds for Treasury bill investments and for money market mutual fund investment.

This aggregates the money, the cash from financial institutions like mine and those in many small towns throughout the country into either the Government hands or the money market mutual funds reinvest that capital in the CD's of the very large money center banks or also in Government securities.

I was at a Wisconsin banking seminar about 3 weeks ago in which a banker in the northwestern part of the State told me that in his bank, $25 million in deposits in a relatively small town, two salesmen for money market funds came to town over a 2-week period, rented rooms in a motel, got on the telephone and walked out of town with $5 million in his deposits and all of those ended up probably in Minneapolis, Chicago, or New York.

Now, if this is being repeated, if that is at all typical of what is happening around the country, I think it spells a very dismal situation for small business because it has to tear apart the local base of an economy in a town like that.

Senator BYRD. I think it does, and as inflation increases or even if it would be half from its present point, it would still be a very high inflation and that, for States, forces the values up artificially and is going to make it very difficult in the future for the middle economic group to survive.

Take the case of a house. The committee had some figures developed that showed that the average cost, or value of a house today, is in round figures $70,000. Now, 20 years from now—and that is not very long, really—20 years from now, the value of that house will be $421,000.

Now, if a man and wife have an estate tied up mostly in that house, that means that the survivor is going to have to sell the home in order to pay the taxes and he or she will have a whale of a tax to pay on property that really has not shown any actual increase in value, only an inflationary increase.

Mr. DERIEUX. Senator, I might add that that is the same problem that the small businessman's estate faces, that they may have to sell the business.

Senator BYRD. Exactly.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

I would make a couple of points. In meeting with small businessmen in my State, they came up with what I thought was a significant idea, and that was that the stress be on simplicity which is the point you have made here, but also they said, do not give them a series of options as to which way they might make the greatest savings.

For example, I was talking to them about a 10-5-3 depreciation proposal in which we would keep the investment tax credit at the current situation; namely, you would get the full investment tax credit at 7 years, but you would get—what is it, three-quarters of it if you went to 5 years?

Mr. DERIEUX. Two-thirds.

Senator CHAFEE. Two-thirds—as it is under the current system. And they said, please have your investment tax credit apply fully to your 5 years coinciding with your depreciation on your machinery. Otherwise, you would put the small businessman into the pickle of having to get an expensive accountant who would then have to tell him, is he better off going with the 7-year depreciation of the full investment tax credit, or the 5-year full depreciation, but only two-thirds of the investment tax credit, and then this option presents him with great difficulties.

That thought had not occurred to me, and it made a good deal of sense. I am not against expensive or inexpensive accountants, but from the small businessman's situation, he just cannot afford to have any more expenses than he should have, after hearing the dire illustration that Mr. Treptow presented.

Mr. DERIEUX. Senator, I think that we accountants do not like to see our clients have to pay us more than would be reasonable for them to pay because of complications in the tax laws so I would agree with that.

Mr. HUNTZINGER. Senator, if I may add, I would concur totally with that. During the conference process, there was some discussion of amplifying the capital cost recovery option to include that type of thing, but we have certain time constraints and that was not developed, but it was seriously discussed and I frankly thought it was a very, very good idea.

Senator CHAFEE. You mean you discussed the investment tax credit?

Mr. HUNTZINGER. To make it coincide, as you have just discussed.

Senator CHAFEE. The point you have made here about the income, personal and corporate, reductions are very valid and of course, we are extremely sympathetic. You are preaching to the choir to a great extent in this committee.

The quandry we are in, of course, you also recognize, is on the one hand we have this tremendous concern for inflation. The feeling that the single best thing we can do to lick inflation is to balance the budget, and at the same time, a corollary with that is to cut taxes, to increase productivity, and stimulate the economy, but all of those things cost some money.

Now, you may get something like, as was previously testified, only issuing a W-2 form at the end of the year, but that, as the witness testified, that was a small step. But any of these significant steps do cost revenue, and so we are in this schizophrenic position of trying to balance the budget and at the same time have these incentives.

Now, I suppose one of the solutions to it is to cut the budget enough so that you have got some leeway left over so thus you can have some of these tax cuts. But I suppose we are going to have enough trouble just cutting the budget to get it down to being in balance, never mind having a surplus.

Mr. TREPTOW. If, in fact, we can balance the budget, and that produces the effect I think we all hope that it will, to stop inflation, that in fact will produce a tax cut.

Senator CHAFEE. Yes, but I do not think that anybody thinks that by balancing the budget this year we are going to significantly reduce inflation. I must say I find so depressing the predictions that a balanced budget will give you 0.3 of a percent reduction in the inflation. I cannot believe that is so.

But even taking that as the worst case, I suppose the best case is going to take you down maybe 0.4, 0.5—well, that would be significant.

But there is the quandry we are in, which I am sure you gentlemen appreciate.

Mr. DERIEUX. We do, and, Senator, I think small businessmen recognize that there will be sacrifices in getting the economy under control, and I think small businessmen are perfectly willing to stand their portion of that. They simply do not want to bear more than their rightful share of that burden.

Mr. HUNTZINGER. If I may add, I think that there can be—this may sound like heresy ~~—but there~~ can be too much emphasis on balancing a single budget. For instance, what is really the better thing to do for the country? To have a fair, equitable, simple tax system that encourages capital formation and productivity in the long run, or balancing a single budget?

I just ask you to think about that.

Senator CHAFEE. I do not think any of us are embarking on this exercise thinking that we are just going to balance the 1981 budget. I think that there is great skepticism here in this committee of embarking on new programs that are just a little modest expenditure in 1981 and a big boom in 1982 and 1983.

So I do not think the mood of the Congress is that we will sneak through 1 year with a balanced budget.

Mr. HUNTZINGER. So then it comes to what is the tax policy that, in the long run, can be made to insure adequate revenues for the spending of the Federal Government?

Senator CHAFEE. Well, I think that every one of these ideas that you have presented us, from the top eight ideas narrowed down to five or however you want to do it from the Small Business Conference are good, plus others that have come along. You know, you may be going a little far when you are talking about cutting the personal income tax rates from the maximum to 70 or getting into gift taxes. There is only so much we can swallow around here at one time.

But I think that the biggest single thing we are concentrating on, I think in the committee as a whole, is the capital formation problem.

Thank you very much, Mr. Chairman.

Senator BYRD. Thank you very much, Senator Chafee.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Continuing along the lines of the discussion that Senator Chafee has raised, I am wondering to what degree should we cut expenditures to balance the budget, and eventually to stop inflation?

We could balance the budget with a tax increase, spending cuts, or even further spending cuts along with all kinds of capital costs and tax measures.

I was wondering if any of you have any feelings on that subject? That is, how far do we go in cutting expenditures?

I have raised the question, keeping other points in mind. The real estate industry, the housing industry, the building industry are hit adversely with high interest rates and they want significant increases in mortgage money.

At the same time, the farmers are in very tough shape around the country. Their costs have increased. They have no control over their price.

I am just curious as to how far you think we should cut expenditures in order to have the money available for tax cuts.

Mr. TREPTOW. Senator, I think part of the dilemma we are in is that this country has become so accustomed to coming to Washington for the solution to these problems and I understand the realtors coming to town and looking for relief. My whole background is farming. I grew up on a dairy farm in Wisconsin. I understand that industry and the dilemma that those people have.

Yet those are only temporary Band-Aid type approaches to the problem. The real reason that the realtors have a problem with the cost of money today is because we have such an exceptionally high rate of inflation.

Measures to provide Federal funds for relief in that area will only be temporary and it may, you know, bring the rates of money down and give that industry a temporary resurgence, but the next time we get to this point in the economic cycle, it will probably be worse and I think we have to start moving away from these kinds of problems.

I do not think we can make that withdrawal instantly and abruptly, but I think we have to start to begin making a commitment that capital investment in this country, increasing capital investment, taking the tax biases and the fiscal biases that preclude savings and investment in this country out of our regulations, out of our tax codes, is eventually going to lead to more productivity, and a more permanent cure for inflation so that in the future it will become less necessary for Government to intervene and, in fact, contribute to an increased GNP.

Senator BAUCUS. Right now the Budget Committees of both the House and the Senate are talking about roughly a $22 billion tax cut for fiscal 1981. If we cut down to 20 percent of GNP, I understand that entails cuts in spending in the nature of $45 billion.

That obviously is going to adversely affect a lot of programs in this country. For example, the defense budget will be affected as people are more nervous about the Soviet Union today than they were a couple of years ago.

I am wondering if you think that we should go all the way down to 20 percent, or should we balance it at roughly $22 billion?

Mr. TREPTOW. Senator, I do not pretend to be intimately knowledgeable about all the intricacies of the budget.

Senator BAUCUS. I am really asking two questions: How are these kinds of actions going to curtail inflation, and what other ways can we curtail inflation in addition to balancing the budget?

Mr. TREPTOW. What you might find interesting, though, is that I never thought of it before, and apparently Government never thought of it before, but when we become desperately concerned about balancing the budget, we come up with little ideas like eliminating Saturday delivery of mail.

Now, you know, maybe I should have thought of this a long time ago, and perhaps a lot of us should have, but you know, that is an idea that seems to be tremendously popular. I have talked to a customer in my bank who objects to cutting mail deliveries on Saturday.

Senator BAUCUS. It is less popular in Montana.

Mr. DERIEUX. I think the idea there is if you would bring my mail, but cut out his, on Saturday.

There is one thing, Senator—this certainly is not a direct answer to your question—but we talked not only about capital formation but capital retention and if the tax laws and the administration of those laws was such that the businessman could retain more, could save and retain a higher portion of his earnings, then he would not have to come to Washington for help in getting through the hard times. He would simply be able to put aside——

Senator BAUCUS. To what degree is the capital retention, or the capital formation, question a function of inflation? Is that 50 percent of the problem? Is that 75 percent of the problem, roughly?

Mr. TREPTOW. I think it is closer to 75 percent of the problem. I think if we can solve the capital formation issue, small business is going to be able to deal with most of the other problems we are talking about.

Senator BAUCUS. If somehow we get together all of this, do you think that will amount to about 75 percent of the capital formation problem?

Mr. HUNTZINGER. I was not sure that I agreed with Dean until now that I know he understands the question.

I think that lower inflation such as the 4 and the 5 that you quoted—boy, those were the good old days, were they not—lower inflation merely sets the stage for a renewed period of capital formation and retention. It, by and of itself, does very little or nothing.

What it does is, OK, from here on, as I earn under an equitable tax system, I can retain better and it is not being eroded under the problems that Dean had in his earlier testimony.

In partial response to you, Senator, 4 weeks ago you asked me that same question. I did not have an answer.

I do not have much of a better one today, but you did rephrase your question a little bit and you did say, balancing the budget by raising taxes.

I read that the other day where it was evidently said very seriously by someone on the Hill and I absolutely went stark, raving mad when I saw it.

I do not even know—now, I am no economist, but even in the short run, I am not sure that a tax increase would balance your budget. I believe it was mentioned in terms of a surtax on income taxes, if your income is over a certain level.

It was done very vaguely and I just thought boy, they are barking up the wrong tree again. In the long run—maybe one budget, Senator, you could balance that way. But in the long run—

Senator BAUCUS. Do not get me wrong. I think there is very little sympathy around here to balance the budget by increasing taxes. I am certainly opposed to doing it that way and I think the vast majority is opposed to it.

I wonder if we could go back to the earlier question that I asked: to what degree is the capital formation problem facing small businessmen generally attributable to inflation?

That is, if we were to stop inflation, how much will businessmen be in a better position to accumulate capital and retain it?

Mr. DERIEUX. I doubt that we can quantify that for you, but inflation is certainly the most severe, or has the most severe effect, on his ability to retain capital, certainly, and to obtain it.

The small businessman would still have some capital attraction problems, even without inflation, but they would be substantially less.

Mr. TREPTOW. Now that I understand the question, Senator, I would say that there is no hope of holding inflation to a 4- to 5-percent level unless we do something serious about capital formation so that we can start adopting the innovations in technology and improve productive facilities in this country that we so sadly need.

Our steel industry is antiquated. We came out of World War II with our productive machinery completely worn out and then helped rejuvenate the productive capacity of those nations that have been whipping the blazes out of us in productivity in our own markets today.

So I think capital formation really lies at the solution to inflation in the long run.

Mr. HUNTZINGER. I think also to the extent that lower inflation rates make the Federal Government withdraw from the credit markets it is definitely to our benefit because again, as Dean mentioned earlier, that with the Government competing, offering 15 percent plus for money, it makes it far less attractive to loan money to a client of mine who is far more risky in the eyes of a bank board.

So I think, to the extent that lower inflation gets the Federal Government out of the credit markets, I think that is a definite benefit to capital formation of private sector and also to the extent that lower inflation has the impact of not rushing us up into the higher tax brackets up quite as quickly, then we also benefit by retaining capital.

So there is a direct relationship, in my judgment.

Senator BAUCUS.

Mr. Treptow, is a banker, do you think that the Federal Reserve's monetary policies are misdirected here.

Often I hear from small businessmen in my home State that the high interest rates are a disproportionate burden borne by small businessmen, by farmers and so forth, whereas the larger banks, Citibank, and large business can better weather high interest rate policies, the discount policies of the Fed, and perhaps even reserve requirements.

Could you shed some light on that, at least from the small businessman's perspective?

Mr. TREPTOW. For one thing, I am very much relieved that the Federal Reserve's policy did not have broad credit restrictions in all aspects of credit, particularly in small business. I was fortunate to have been invited to a meeting with Mr. Alfred Kahn and some of the White House staff about a week or two prior to the President's budget message in which he asked the Fed to insert those credit controls, and I stated to Mr. Kahn at the time that if we institute credit controls that affect all business borrowing, small and large alike, the effect would probably be absolutely devastating to the small business sector, because their source of funds is primarily from the banking system.

I have looked at statements of my own small business bank customers. I have talked to other bankers and accounting firms—this is not an indepth or definitive study, but a rather casual study by a lot of people would seem to indicate that the accounts receivable of small businesspeople have been extended about 20 days in collection time over the last 6 months.

Now, it is also basically true that small business people sell to large customers, particularly small manufacturers and distributors are selling to large companies. In effect, what has happened is these large companies have borrowed about 20 days worth of interest-free money through the payment of the payables due these small manufacturers.

If we exert credit controls, there will be even further impetus for the stretching out of those receivables, more borrowing requirement in the small business. If he cannot get it from the bank, he is dead.

Meanwhile, large business can circumvent Fed controls by borrowing overseas in the Eurodollar markets issuing commercial paper, perhaps—now, that has been restricted in the ultimate policy. But overall, I think the Fed is doing what it has to do.

Our Independent Businessmen's Association in Wisconsin attended the congressional presentation—we participated in the annual Washington presentation which took place 2 weeks ago.

Our Wisconsin delegation met with Paul Volcker from the Fed on the hour
and a half with him.

Overall, the sentiment of our people from Wisconsin was to support what the Fed has done in being a tough discipline necessary to get a handle on this inflationary problem.

Our group was supportive.

Senator BAUCUS. Would you revise these policies in any way? Do you think that the high interest rate policy as implemented by the Fed to date falls disproportionately upon small business? If you were the Chairman of the Fed, would you revise his policy in any way?

Mr. TREPTOW. I do not think that the credit controls, as such, are ultimately going to work. I am glad they were not imposed on small business. Again, I am supportive that it said specifically in the regulations, special attention should be given to meeting the credit needs.

However, I really do not think that the Fed is the real problem in this area.

One of the problems that really falls disproportionately on small business is this concept that we have now with the money market CD's and other vehicles where the Government is, in fact, competing for private sector capital.

You know, that whole money market CD concept, which was originally designed to allow the private sector, banks, savings and loans and thrift institutions to compete with the Government for capital is self-defeating so long as Government has an increasing appetite for this capital that is in the marketplace.

Because each week at that Treasury bill auction, the market readjusts and the Government pays a rate, draws what capital it needs to fund that week's debt sales out of the private sector. The next week when it needs more money, the only way it can unbalance that equilibrium again and get more money from the private sector, from the banks and the thrifts, is to offer a higher rate, or be willing to pay a higher rate, and this is escalating and this has to continue, I believe, until—going back to the budget balancing situation, Government stops increasing its appetite for funds.

Senator BAUCUS. You seem to be saying that the availability of money is a greater problem than the cost of money.

Mr. TREPTOW. Absolutely, yes.

And I think if the availability of the funds are there, the rates will take care of themselves. I think the rates are largely due to the Government and large institutional competition for these funds, and concentrating them into fewer and larger hands.

Senator BAUCUS. You sound like a good Montana banker, too. We have the same problem.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Senator Baucus.

I want to comment just on two things.

First I want to say that the only group, only agency, only individual who gains by inflation is the Federal Government. The Federal Government is the beneficiary of inflation.

Maybe that is why we are not getting inflation under control.

Now, let's get to the question of the budget. I think that people are being misled—I want to say this frankly.

On January 28, President Carter submitted his budget. It called for spending $616 billion.

He realized that he had misjudged the economic situation. He realized he had misjudged the politics of it, so on March 14 he revised that.

Yesterday, he revised it again. Now, yesterday, he recommended spending $612 billion instead of $616 billion.

Now he is saying that he is going to have a big surplus. Now, how does he get that surplus?

On January 28, 2 months and 3 days ago, he estimated revenues to be $600 billion. Yesterday, he estimates revenues to be $628 billion.

Now, if anyone feels that that is a very sound approach to matters, or if it is going to have any real impact on inflation, frankly, I do not see it.

He is not reducing spending. He is increasing spending to $612 billion in fiscal year 1981. This is $64 billion more than the Congress only 4½ months ago approved for spending in this fiscal year 1980.

Four and one-half months ago, the Congress approved spending in 1980, fiscal 1980, $548 billion. Now, the President proposed to spend next year $612 billion.

That is no reduction in spending. That is a tremendous increase in spending, a tremendous increase.

And yet the headlines and the radio and the television and Congressmen and Senators and so forth say, oh, we are going to balance the budget. We are going to get spending under control. We have gotten it under control. We are reducing spending.

That is a lot of bunk. It is being tremendously increased.

What I contend needs to be done is not to reduce spending below what we are spending in 1980—we cannot do that—but we can reduce substantially the tremendous increase which is being proposed. Until that is done, in my judgment, we are not going to get on a sound basis.

Mr. Huntzinger, you mentioned tax expenditures. There is a school of thought in Washington which takes the view that everything an individual earns belongs to the Federal Government and that he or she can keep only what the Government permits him or her to keep.

My belief is, and I think it is the belief of this panel and most of the American people, for that matter, that what an individual earns belongs to the individual, but the Government has the right and the responsibility to take what is necessary to operate the Government.

Now, for example, a person borrows money to pay a mortgage on his home, or to buy an automobile, to say that the deduction for the interest that he pays is a tax expenditure the same as if it were appropriated by the Federal Treasury, it seems to me, is just total nonsense.

So I do not pay any attention to those figures of tax expenditures at all. A man contributes to a church. There is school of thought around Washington, D.C. that is a tax expenditure, because if he had not contributed it to the church, the Government would have gotten more money.

Expenditures of the Federal Government, what it means to me, is what the Government itself spends to operate Government and to take care of the various functions of Government. That is Government spending.

When an individual contributes to his church or college or any other lines of endeavor, that to my way of thinking, is certainly not a Government expenditure.

Mr. TREPTOW. Mr. Chairman, it was worth the trip to Washington to come here and hear you say that, and I can assure that the small business people of Wisconsin heartily agree with that.

Senator BYRD. Thank you, sir.

Thanks to each of you. You have made a fine contribution and we appreciate your being here.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 707.]

SUMMARY OF
PRESENTATION TO
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
APRIL 1, 1980
BY
THOMAS E. HUNTZINGER, CPA

Capital Formation was the main area singled out for significant action by the White House Conference on Small Business. (P.1)

Need a plan of action for the future to ensure economic stability. (P.2)

Small Business Capital Formation Act - Combine the major principles of S. 487, S. 653 and S. 1481 and pass such a bill in the near future. (P. 2-3)

Small Business Equalization and Simplification Act - Inequities in the Code that discriminate against non corporate business-people should be rectified. Simplification of depreciation system and LIFO valuation of inventories should be affected. (P.3-5)

Capital Retention Act for the 1980's - The corporate surtax exemption should be phased in to $500,000 over ten years. The maximum tax on individuals should be phased in to a maximum rate of 50% over five years. (P. 5-7)

PRESENTATION TO

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION

AND DEBT MANAGEMENT

APRIL 1, 1980

BY

THOMAS E. HUNTZINGER, C.P.A.

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Delegate to 1980 White House Conference on Small Business

Moderator for Capital Formation Workshop Sessions, White House Conference

The 1980 White House Conference on Small Business presented sixty specific recommendations as its mandate for action during the 1980's. If one major area can be singled out as being the focal point of the mandate it is Capital Formation. The five options relating to Capital Formation finished first, second, third, seventh and nineth in the priority ranking of the entire Conference. Therefore, if the Federal government wants to respond to the wishes of the Small Business community, it must act on the proposals put forth in the Capital Formation area.

The issue refinement process of the Conference was thorough and approximately one half of the delegates took part in the Capital Formation Area. I was a delegate moderator for the Region Three meeting of delegates in October, 1979 and both days of workshop sessions at the January, 1980 conference. I also was the Capital Formation chairman for the Philadelphia delegation. In the above capacity, I came in contact with approximately ten percent of the delegates. The recommendations in this paper represent a combination of my personal views based upon my professional experience as a practicing certified public accountant as well as the views of hundreds of delegates to the White House Conference. The recommendations will blend the Capital Formation options, and existing legislative proposals where feasible, into a Small Business Capital Retention and Formation plan of action. The emphasis will be on income taxation and related proposals since that was the emphasis of the Conference as demonstrated by eighty eight percent of the delegates voting for a reduction in corporation and individual income taxes.

The Congress must deal affirmatively with the tax cut issue in spite of the current budget balancing efforts. The government does not have a problem of too little revenues but of too much in expenditures. What we want is a committment for lower incremental tax rates to allow for retention of capital. Such retention will in turn earn more income which will in turn increase tax revenues. This nation needs a long term plan of economic action in order to avoid many of the problems we are experiencing currently. Such a long term plan must begin with a committment to an equitable system of taxation that encourages investment and productivity. Our current system needs many changes to achieve that end.

I envision three "packages" of legislation that can achieve what the delegates want. The first, with little "cost" to the teeasury, deals primarily with attracting capital to the small business sector. The second deals with achieving equitable treatment of certain items between corporate and non corporate taxpayers and other simplification matters. The third deals with the phasing in of lower tax rates.

SMALL BUSINESS CAPITAL FORMATION ACT

This "package" should encompass the major principles of three Senate Bills, namely S. 487, S. 653, and S. 1481.

S. 1481 - The delegates felt that the Small Business Participating Debenture was the most innovative vehicle for capital formation to come along in a long time. If passed near its present form, it could become a valuable, and flexible means for a small businessman to obtain fresh funds that otherwise is not obtainable from banks and without the red tape of an SBA loan. There can be little reason for delay in passing this legislation.

S. 487 - S. 653 - The delegates felt that the gain on the sale of any capital asset should be deferred to the extent that the proceeds are invested in a small business. Such a broad proposal is necessary if we are to attract "fresh" capital into the small business sector. While a restrictive rollover provision for deferring the gain on the sale of a small business if another small business is acquired would be a step in the right direction, it would not attract new capital to our sector.

While the emphasis of the delegates was on the rollover provision, they did feel that it might be helpful if one could obtain an "investment" tax credit for direct investments in a small business. This credit should not be limited to new registered securities because only a small percentage of small business would benefit in that event. Obviously, certain "recapture" provisions would have to be a part of such a bill.

SMALL BUSINESS EQUALIZATION AND SIMPLIFICATION ACT

This phase is necessary because its elements deal with some of the reasons that the tax cut proposal became so overwhelmingly popular. My phase three proposals can neither be fully understood nor dealt with until some of the inequities that created its need are properly handled.

EQUALIZATION SUBSECTION - One must always keep in mind that over eighty percent of Small Business is unincorporated. Therefore, many of the perquisites available to some small business people are not available, or at least to the same extent, to others. Why can a corporate small business man deduct health, disability and life insurance premiums and generally, a non corporate small businessman cannot? Why can a corporate small businessman put away up to twenty five percent of his personal earnings into retirement plans, and a non corporate small businessman can only put away fifteen percent of the first $50,000 in earnings?

The insurances enumerated should be deductible by corporate and non corporate businessmen. This provision is a matter of fairness and would probably not involve a significant "cost" to the Treasury.

The more significant item however is an expansion of the "Keogh Plan" deduction. The fifteen percent limit should be phased in to a maximum of twenty five percent over a two year period. The maximum annual deduction should be phased in so as to coincide with current corporate limits. Aside from the fairness issue there is another highly favorable reason for doing this.

Many small businesspeople fund their Keogh Plans at local banks. The impact of (say) doubling the potential Keogh deposits at banks can be significant in the long run. More money remains in the local community for lending to other small businesspeople. Now we're talking about both capital <u>retention</u> and capital formation!

SIMPLIFICATION SUBSECTION - There are two major items in this section, LIFO and depreciation simplification.

The Treasury has been studying a form of simplified LIFO for some time and supposedly endorses the idea. Annual industry indexes should be published and be made available for use by the small businessman who is currently overwhelmed by the technicalities of LIFO. Enough work has been done in this area for prompt action.

(S. 1435) Some form of simplified, accelerated depreciation must be passed soon. The ADR system is not being used by the small business community because it is seen to be complex and inadequate. The provisions of S. 1435 generally meet the wishes of the delegates to the White House Conference. However, the transition period provisions could be difficult for many to cope with and I'm afraid of the "Secretary to Prescribe Regulations" section. If Moses had the IRS make the appropriate regulations the Ten Commandments would be in ten bound volumes rather than on a single tablet.

THE CAPITAL RETENTION ACT FOR THE 1980's

This is the legislation that Congress must committ to now in order to ensure a healthy private sector for the future. The Act should have two sections, one dealing with corporation taxes and one with individual taxes.

CORPORATION TAXES - Over ninety percent of the corporation income tax returns are filed by small businesses. Thus, increases in the surtax exemptions benefit small business in a greater proportion than "big business". The delegates to the Conference expect a phase in of a higher limit on the surtax exemption. A reasonable phase in schedule would be as follows -

Upper Limit	Year
$125,000	1981
150,000	1982
175,000	1983
200,000	1984
250,000	1985
275,000	1986
300,000	1987
350,000	1988
400,000	1989
500,000	1990

The incremental brackets would be appropriately adjusted to reflect a reasonable progressivity of the tax rates.

It is important to educate the public that corporate tax breaks really go to small business. The reduction in taxes effective January 1, 1979 was a seven percent cut for a company earning $100,000 a year, but only a negligible cut for a large corporation earning $100,000,000 a year.

INDIVIDUAL TAXES - Over eighty percent of Small Businesses are unincorporated. Therefore, any serious discussion of Capital Formation must include the merits of a reduction in personal income taxes. The steep progressivity of the individual income tax rate schedules has the effect of taxing the reinvested earnings of unincorporated businesses at potentially higher rates than incorporated businesses.

The delegates to the White House Conference on Small Business approved the tax cut option with wording that included reducing the maximum tax rate from seventy percent to fifty percent. There is no doubt but that rates in excess of fifty percent are regressive. There can be no moral or economic reason for the government to take more of one's earnings than he is allowed to keep.

There is another way to view this situation from a capital formation point of view. Non corporate taxpayers can be subjected to rates of up to seventy percent on their business earnings to the extent that the income is derived from the employment of capital!

That's incredible! We're here today talking about capital formation at a time of the year when capital is being taxed more heavily than other types of income. In light of the above, I would propose lowering the maximum tax rate as follows -

Rate	Year
68%	1981
62%	1982
58%	1983
52%	1984
50%	1985

Appropriate expansion of the tax brackets should correspond with the timing of the above reductions.

There are those who will say that now is not the time to move on such an aggressive program, but they are wrong. Now is the time for the Federal Government to committ itself to a revitalization of the free enterprise system. In the long run, budgets are not balanced by increasing taxes, that only discourages investment and productivity. We should probably be less concerned about balancing one budget in the short run than balancing all of the budgets in the long run. I pledge my support and efforts to a progressive long range plan of action that will allow small business to continue to be the keystone of our free enterprise system.

Testimony of

Samuel A. Derieux, C.P.A.
Richmond, Virginia

Reporting on
Homestead Small Business Tax Conference
March 27-29, 1980

Before Joint Hearings
of the
Senate Committee on Finance
and the
Senate Select Committee on Small Business
April 1, 1980

CONTENTS

REMARKS OF SAMUEL A. DERIEUX

April 1, 1980

The purpose of these remarks is to report the results of the Homestead Small Business Tax Conference, held in Hot Springs, Virginia, March 27 through 29, 1980.

The Conference participants recognized that the term "small business" encompasses both privately held enterprises and smaller publically held companies. Both of these types of small businesses have encountered difficulty in obtaining and retaining adequate capital.

To facilitate capital formation by small businesses, the Conference, among other things, endorsed (a) the concept of a value added tax, but only subject to certain conditions, including an accompanying permanent reduction in income taxes, (b) a small business capital gains rollover, (c) a new form of small business participating security, including a related investment tax credit, (d) a reserve for market makers in small business stock, and (e) a number of measures influenced by recent inflation. The Conference rejected, among other things, the concept of automatic "indexing" of the tax laws to inflation. To appreciate the Conference results, it is essential to know something of the background of the Conference, its purpose, the topics chosen for discussion, the nature of the participants, and the Conference format.

Background. The Conference was sponsored by the Small Business Committee of the Section of Corporation, Banking and Business Law of the American Bar Association. Although I attended the Conference, I am not a lawyer or a member of the ABA, and much of my information regarding the Conference planning was related to me by those who participated in that planning.

The stated aim of the Conference was to develop proposals to amend the Internal Revenue Code to facilitate capital formation and retention by small businesses, without significant adverse social impact. It grew out of a similar conference conducted by the same sponsors in September, 1979 at Snowmass, Colorado. The Snowmass Conference proposed amendments to state and federal securities laws and regulations. The proposals were designed to eliminate unnecessary burdens on the efforts of small business to attract investment capital. The participants at Snowmass I have talked with were enthusiastic about is results. I am told that many of the regulatory proposals developed there have been favorably received and some have been implemented by the Securities and Exchange Commission. It was quickly realized, however, that no amount of favorable developments in the securities laws would be sufficient to attract significant new capital into productive small businesses without some shift in the risk-reward balance struck by the federal tax laws.

The Topics. Beginning in September, 1979, the sponsors selected from a list of numerous possible choices seven topics they felt to be of critical importance to small businesses. The seven topics, described in detail in the "Summary of the Topics" accompanying these remarks, were the value added tax, stock benefit plans for key employees, the capital gains rollover concept, small business participating security, tax adjustments for inflation, inducements for innovation and the concept of a reserve for market makers in small business stock. The selection was fortunate indeed, as there has since been much interest in, and in some cases legislative proposals have been introduced regarding, these topics. The sponsors prepared background papers on each topic and collected other relevant materials intended to stimulate discussion among the Conference participants.

The Participants. The participants were a diverse group of seventy exceptionally talented men and women. They came from all parts of the country at their own expense to help develop rational alternatives to ameliorate this very serious economic and social problem: the increasing inability of small businesses to attract and retain needed capital.

Each participant was invited on the basis of his or her background and ability to contribute to the deliberations. As reflected by the biographical sketchs submitted with these remarks, they included certified public accountants, economists, bankers and brokers, lawyers, scholars, federal agency and Congressional staff members and businessmen from various industries. Each committed to study the background materials in advance of the Conference and prepare to lead a discussion of one of the seven topics.

The Conference Format. The Conference format is described in detail in the "Explanation of the Conference" submitted herewith. Essentially, it was a discussion-type conference conducted in the "Packwood" style. The participants were divided into discussion groups which included two topic leaders for each of the seven topics. Each group debated each topic and possible solutions. Thereafter, topic leaders from the discussion groups joined their counterparts from the other groups to form seven drafting groups, one for each topic. The drafting groups further debated, drafted and distributed written proposals on their respective topics for consideration by all participants. At a final plenary session, all proposals were considered, amended where appropriate, and voted upon by the participants.

Conference Results. The specific results of the Conference are set forth in the accompanying "Proposals," a 26-page document which describes, by topic, under the heading "Proposed Solutions," the proposals submitted by the drafting group for a vote of all participants and under the heading "Results of Plenary Session," the action of the conference on the proposals related to that topic.

The Conference made no attempt to propose specific language for legislation or to use tax terms of art with the sort of precision required for legislative drafting. The principal focus was on the expression of concepts based on considerations of economic, social, business and tax policy.

As indicated above, the participants endorsed the concept of a value added tax, provided that its adoption be accompanied by strict guarantees of a permanent reduction in income taxes and that it be structured in a manner designed to encourage savings and investment relative to consumption. The participants were, however, concerned with potential abuse of and complexity of administration of the tax, and urged that it be stated on invoices rather than included in the purchase price of goods and services, and that a flat rate be applied, without exception. The participants narrowly endorsed utilizing the proceeds of the value added tax to relieve the burden of social security taxes and rejected by roughly a two-thirds vote a proposal that the tax be adopted only it its regressive nature be significantly ameliorated.

With respect to stock benefits for key employees, the participants endorsed proposals to permit small business to grant "small business stock options" (as defined by the proposal) without incurring a current tax, to permit employees of small businesses to defer the payment of tax until ultimate disposition of the securities, and to make available section 1244 treatment to small business employees in the event that stock awarded to them should subsequently become worthless or is sold at a loss.

The participants endorsed the capital gains rollover for gain realized upon the sale of a small business investment (or an investment which, when made, qualifed as a small business investment), provided that the proceeds are reinvested in another small business investment within 24 months. The participants recommended that retiring entrepreneurs be permitted a one-time rollover (subject to an unspecified dollar limitation) provided that the proceeds are reinvested in any business or businesses within the 24-month period, whether or not the new investment is in a "small" business.

The participants endorsed the adoption of an investment tax credit for investments in "Small Business Participating Securities," which offer both a fixed rate of interest (taxed as ordinary income to the investor and deductible as an expense by the issuer) and additional contingent interest keyed to sales, earnings or some other indicator of positive business performance (taxed as long-term capital gain to the investor and deductible as an expense by the issuer).

The participants rejected, as a means of coping with the problems of inflation as they apply to small businesses, the concept of "indexing" to inflation the various dollar amounts stated in the Internal Revenue Code, but endorsed proposals

(a) to simplify LIFO inventory rules, (b) to adopt a new graduated corporate income tax schedule, (c) to increase the accumulated earnings tax credit, the Section 1244 ordinary deduction limit and the gift tax exclusion, and (d) in general terms to permit more rapid recovery of investment in depreciable assets.

To encourage greater innovation, the participants recommended that capital gains taxes be further reduced, that Subchapter S status be made available to corporations with up to 100 shareholders, and that other corporations, partnerships and trusts be permitted to be shareholders of Subchapter S corporations. In addition, the participants urged that the Section 172 net operating loss carry forward be allowed as a deduction for an unlimited period, and that long-term capital gains treatment be made available to corporate and other patent holders as well as to individual patent holders and that such treatment also be made available to transfers of patent rights that are subject to "field of use" or geographic restrictions.

Finally, as a solution to the limited liquidity of investments in small business securities, the participants endorsed the establishment of a tax-deferred reserve for market makers in small business securities. Because this concept as embodied in pending S. 1967 would assist in adding to the depth and liquidity of issues of small business securities and in their financing, the participants recommended that this legislation be adopted, although the participants did urge consideration by Congress of certain technical modifications to S. 1967 that would, among other things, extend the availability of the deferral to non-corporate as well as to corporate broker-dealers and encourage continuation of market making activities.

The Homestead Small Business Tax Conference was a unique and extraordinarily meaningful event. Its recommendations to encourage a more productive and competitive economy were arrived at through intense debate and thoughtful reflection by a diverse group of extremely talented and articulate citizens who were not bound to any particular constituency. I respectfully urge your favorable consideration of its results.

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HOMESTEAD SMALL BUSINESS TAX CONFERENCE

SUMMARY OF THE TOPICS

The following is a summary of the topics to be considered at the Homestead Small Business Tax Conference:

1. Adoption of the Value Added Tax. The consumption based Value Added Tax ("VAT") is a tax levied on the value added to goods and services by each business entity at various levels in the production and distribution chain. Typically, each business in the process collects the VAT on its sales, takes a credit for any VAT it has paid on purchases and remits the net amount to the government. The result is an indirect tax levied on consumption that is borne by the final consumer of the goods or services. VAT is currently in use in one form or another in numerous foreign countries, including many countries in Europe and South America, and legislation to adopt VAT in the United States in connection with a reduction in personal and corporate income taxes, capital gains taxes and payroll taxes has been introduced in Congress. Proponents of VAT argue that, among other effects, a consumption based tax will result in increased efficiency and productivity in business and will encourage savings and capital formation. In addition, they argue that VAT will offer certain additional advantages that particularly benefit small business, including lower payroll expenditures and better cash flow. On the other hand, opponents of VAT argue that the tax is regressive, inflationary and hidden, that its administrative costs and burdens will have a disproportionate impact on small business, and that it will further erode the few competitive advantages that are currently available to small business under the income tax. This topic will consider these various arguments, especially as they relate to the impact of VAT on small business.

2. Compensating Key Persons in Small Business with Stock. To attract and retain key employees, a small business will frequently desire to provide its key personnel with a "piece of the action." Under current law, however, if stock is awarded to an employee or is sold to him at a bargain price as compensation for services, the market value of the stock (or in the case of the bargain sale, the difference between the market price and the bargain price) will be taxable to the employee in the year of receipt or purchase at "ordinary income" rates. Moreover, resale restrictions imposed by federal and state securities laws often prevent the use of the stock to raise cash to pay the tax. Stock options may be awarded to avoid a current tax, but the problems for the employee are merely postponed. Not only does the eventual exercise of the option require a cash expenditure by the employee, but if the market value of the stock has increased the employee will also be required to pay tax at "ordinary income" rates on the difference between the amount paid upon exercise and the fair market value of the stock at the time of exercise. This topic will consider several proposed solutions to the problem of compensating key employees with stock, including: (i) reinstitution of qualified stock option plans, but only for companies which meet "small business" criteria; (ii) deferral of income tax with respect to stock issued to employees of such small businesses, with long-term capital gains treatment available upon the disposition of the stock if it is held for a certain period; and (iii) the

granting of ordinary loss treatment as an offset to previously paid "ordinary income" tax in the event that stock issued as compensation for services subsequently declines in value or becomes worthless.

3. The Capital Gains Rollover. In response to concerns that additional tax incentives are needed to encourage investment in small business, various proposals have been suggested that would permit investors to defer the payment of tax on gain realized upon the sale of stock or operating assets in certain transactions involving investments in small business, provided that the gain is reinvested by the investor in other qualifying businesses or assets within some limited period of time after the sale. This deferral is known as the "capital gains rollover." This topic will consider the impact that the capital gains rollover might have on small business investment and how the rollover might best be structured. Specific questions include how "small business" should be defined for purposes of the rollover provisions, what period of time should be permitted for reinvestment of proceeds, how long an investment period should be required to qualify for rollover treatment, and whether repeated rollovers should be permitted. In addition, the discussion will consider whether the rollover treatment should be available only when the proceeds of one small business investment are invested in another small business or whether such treatment should also be available in "large-to-small" or "small-to-large" transactions as well, and whether the investor who has deferred capital gains taxes pursuant to the rollover should be permitted to avoid capital gains taxes altogether on his investment if he dies before the deferred capital gains taxes have become payable.

4. The Small Business Participating Debenture. Another proposal for encouraging investment in small business involves the adoption of certain tax incentives for use in connection with a hybrid form of security known as the Small Business Participating Debenture (the "SBPD"). As proposed, the SBPD would have the status of a debt security and would carry a stated maturity date and interest rate but would also provide for the payment of a premium based on earnings. This participation feature and its potential for increasing the investor's return would be intended to permit the issuing small business to raise capital at a lower fixed interest rate than it would otherwise be required to offer in order to compete successfully in the conventional debt markets. In addition, it has been suggested that the debt features of the SBPD would be attractive to investors who prefer equity positions but are concerned with the illiquidity and other problems often faced by minority shareholders in small businesses. This topic will consider various tax advantages that might be added to the Internal Revenue Code to make the proposed SBPD's more attractive to investors, including the adoption of a "capital formation credit" similar to the investment tax credit, long-term capital gains treatment for the premium, and an ordinary loss deduction in the event of loss of principal similar to the treatment now provided for losses on shares of stock issued by certain small businesses.

5. Assisting Small Business in Coping with Inflation. The adverse impact of inflation is especially severe on small business. The Internal Revenue Code does permit business to utilize for tax purposes certain accounting techniques that are intended to offset the artificial impact of

inflation on business income, such as last-in-first-out ("LIFO") inventory pricing, accelerated depreciation schedules and alternative methods for determining the depreciable lives of certain assets (Asset Depreciation Range, or ADR). However, these techniques have proven both expensive and complicated to utilize, and studies indicate that few small businesses take advantage of them. Various other provisions in the Internal Revenue Code that are intended to benefit small business (such as the accumulated earnings tax exemption, the limitation of deductions for losses on shares of stock issued by certain small businesses and the graduated corporate income tax schedule) contain dollar limitations that are not keyed to inflation and may, therefore, fail to provide the benefits and incentives they were intended to offer. This topic will address various tax proposals to assist small business in coping with inflation, including: (i) that the LIFO and depreciation rules be simplified; (ii) that the fixed dollar limitations included in the various "small business" provisions of the Internal Revenue Code be updated to account for inflation; and (iii) that a new deduction be permitted for "maintenance of capital."

6. Tax Incentives for Innovation. The development and commercialization of new products and processes is important to the American economy, and small business has traditionally played a significant role in the overall innovative effort. However, small businesses frequently face impediments to innovation that are not equally shared by large companies, and there is increasing evidence that innovation by small business is declining. This topic will address various proposals for encouraging small business innovation through the tax laws, including: (i) that defined "small innovative enterprises" be granted an unlimited carryover period (instead of the current 7 years) for deducting net operating losses; (ii) that certain costs related to the acquisition of technology and depreciable research-related equipment be made deductible; (iii) that amateur inventors who are not "in business" be allowed a current or deferred deduction for research and experimental expenditures; (iv) that the current deduction for research and experimental expenditures be replaced with a tax credit; (v) that the long-term capital gains treatment now available to individual holders of patent rights upon the transfer of those rights be made available to corporate holders of patent rights; and (vi) that long-term capital gains treatment be permitted for transfers of patent rights that are subject to "field of use" or geographic restrictions.

7. Establishment of Special Tax-Deferred Reserves for Market Makers in Small Business Securities. Recent studies confirm that a major disincentive to small business capital formation is the limited liquidity and marketability that investments in small business typically offer to investors. In response to this problem, it has been proposed that market makers in small business securities (i. e. broker-dealers who maintain inventories in certain securities and who are willing to purchase or sell those securities to or from investors at published prices) be permitted to establish tax-deferred reserves similar to the reserves that are currently available for the banking and insurance industries. Such reserves would permit broker-dealers to defer the payment of taxes on profits from market making activities in small business securities, thus providing broker-dealers with some protection against losses from small business securities transactions. Proponents of the deferred reserves assert that

these incentives would encourage expanded market making activities in small business securities, thereby improving their marketability. In addition, they assert that these reserves, if properly structured, could be used to discourage the growing trend of mergers among the small broker-dealers who are typically more active than their larger counterparts in small business securities transactions. This topic will consider generally the proposal for establishing special tax-deferred reserves for small business market makers as well as the specific features that should be included in order to maximize the incentives to small business capital formation that such reserves would be intended to provide.

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HOMESTEAD SMALL BUSINESS TAX CONFERENCE
EXPLANATION OF CONFERENCE
(March 27, 28 and 29, 1980)

Conference Objective

The aim of the conference was to provide a method to thoroughly examine seven tax issues (a summary of which are submitted herewith) and suggest proposals for revision of the federal tax laws in an effort to reduce burdens and facilitate capital formation for small business, without significant adverse social impact.

Participants

Participants were invited on the basis of business, professional or academic backgrounds impacted by, or otherwise concerned with, the topics to be considered and their economic, social or legal effect. An effort was made to keep the group diverse. As appears from biographical sketches submitted herewith, the conference included tax lawyers, economists, CPA's, business school professors, bankers, investment bankers, brokers, businessmen, and staff of the Congress, federal agencies and others. Except for a few introductory remarks, there were no speakers at the conference, but as explained below each participant was assigned one of the topics and was one of two persons designated to lead the group discussion of that topic. Each participant was asked to spend time in advance of the conference to study his or her assigned topic and to collect materials that might enhance the discussion.

Conference Format

The conference was conducted in three phases. The first part involved meetings of separate discussion groups of 12 to 14 persons each, and each group discussed all of the assigned topics. The second part was meetings of seven separate drafting groups for each topic in which the participant met with all other participants assigned to the same topic. The final meeting was a general meeting of all participants at the conference, and at that meeting all the alternative proposals were voted upon.

Separate Discussion Groups

Each discussion group was composed of 12 to 14 persons and met during the day Thursday, March 27 and on Friday morning, March 28. There was a "Group

Leader" to encourage compliance with the conference format. Two persons in each group were assigned to a particular topic. However each participant in the discussion group was encouraged to offer his or her thoughts on all the topics. The discussions were divided into one-hour segments and each topic was discussed for one hour. If a topic required, in the view of the Group Leader and participants, more than one hour of discussion, the schedule was constructed to provide extra time at the end of the discussion sessions for such purpose.

Drafting Session

The Friday afternoon drafting session followed the discussion group meetings. Those seven separate meetings, one on each of the seven topics, were attended by those persons assigned to the particular topic. The purpose of each of the drafting sessions was to rework the various solutions proposed in the discussion groups and draft sequential proposals and discussion on the specified topic. The objective was to have final drafts suitable for consideration at the plenary meeting. Each of the seven separate drafting groups numbered the various proposals on its topic in sequence as determined by vote of those attending its particular meeting. The proposal receiving the most votes was numbered "1", that receiving the next largest number of votes "2" and so on.

A stenographer was in attendance at each of the seven separate drafting groups so that written drafts could be reworked during the session. Each of the seven stenographers working with a drafting leader put the alternative draft proposals in final form, numbered appropriately. Immediately following the session each paper produced by each of the drafting groups was collected and reproduced in copies of sufficient number for all participants at the conference. Each participant was given a set of all proposals with respect to each topic for review prior to the meeting of the entire conference.

Plenary Meeting

The final meeting on Saturday morning was a meeting of the whole for the purpose of voting on each proposal. Individual comments were limited to one minute or so and discussion preceding each proposal to about 10 minutes. To be adopted, a proposal had to be approved by a majority of the participants.

63-769 O - 80 - 43

<u>Conference Schedule.</u>

The actual schedule followed at the conference was as follows:

March 26, 1980 - Wednesday
4:00 p.m. to 10:00 p.m.
Registration

March 27, 1980 - Thursday
8:00 a.m. to 9:00 a.m.
Registration

9:00 a.m. to 10:00 a.m.
Opening session at which participants were welcomed; the operation of the conference was explained.

10:00 a.m. to 12:15 p.m.
Discussion session for topics No. 1 and No. 2, one hour each, with 15 minute recess.

12:15 p.m. to 1:30 p.m.
Lunch

1:30 p.m. to 5:45 p.m.
Discussion sessionfor topics No. 3 thru No. 6, inclusive, one hour for each, with 15 minute recess.

March 28, 1980 - Friday
9:00 a.m. to 12:15 p.m.
Discussion session for topic No. 7 and any unfinished discussion of any of the topics, with 15 minute recess.

12:15 p.m. to 1:30 p.m.
Lunch

1:30 p.m. to 5:30 p.m.
Drafting session: meeting of separate drafting groups, one for each of the topics, with 15 minute recess.

March 29, 1980 - Saturday
9:00 a.m. to 12:30 p.m.
Plenary meeting of the conference.

12:30 p.m.
Conference ended.

PROPOSALS
HOMESTEAD TAX CONFERENCE

TOPIC: Value Added Tax

SUMMARY OF PROBLEM ADDRESSED: The consumption based Value Added Tax ("VAT") is a tax levied on the value added to goods and services by each business entity at various levels in the production and distribution chain.

PROPOSED SOLUTIONS:*

First: A VAT should not be adopted under any circumstances.

Second: The major reservation in respect of adoption of VAT is distrust of the stated intention of government to reduce other taxes and keep both them and VAT down.

Third: A VAT should be adopted if and only if iron-clad guarantees of permanent reduction in income tax are enacted.

Fourth: Adoption of VAT in conjunction with a reduction of income tax is likely to have a favorable impact upon savings and investments.

Fifth: Any tax restructuring which includes VAT must encourage savings and investment relative to consumption.

Sixth: If a VAT is adopted the tax should be disclosed on the invoice rather than hidden in the stated sales price.

* See "Results of Plenary Session" under this topic to determine which proposals were adopted, amended or rejected.

<u>Seventh</u>: If VAT is adopted the proceeds should be used in part to reduce the burden of social security.

<u>Eighth</u>: VAT should not be used to fund social security.

<u>Ninth</u>: VAT should not be adopted unless a significant provision is made to ameliorate the regressive nature of the tax.

<u>Tenth</u>: VAT would be an important factor in improving balance of payments.

<u>Eleventh</u>: Considerations relating to short term inflationary impact, cash flow problems for smaller businesses, and negative impact of VAT upon marginally profitable businesses are important but do not weigh as heavily as other factors in consideration of VAT.

<u>Twelth</u>: VAT should be adopted if and only if the double taxing effect of the corporate income tax is eliminated.

<u>Thirteenth</u>: VAT, if adopted, should be at a flat rate, without exceptions, and other vehicles should be used to remedy any perceived inequities.

TOPIC: Value Added Tax

RESULTS OF PLENARY SESSION

Adoption of a value added tax was essentially unanimously adopted with the strong caveat, also unanimous, that there be "iron clad" guarantees that the concurrent income tax reductions be permanent and that VAT not be increased in the future. That is, the first proposition was rejected and propositions two and three were adopted overwhelmingly.

The reasons overwhelmingly in support of adoption were the perceived positive effect upon savings and investment and reduction in the burden of income taxation. That is, the fourth and fifth propositions were adopted essentially unanimously, as was proposition eleven. The tenth proposition carried by roughly two thirds.

Use of VAT fruits to reduce the burden of social security taxes (propositions seven and eight) was narrowly approved. By implication, this effect was not an important consideration.

Linking amelioration of the regressivity of VAT to any VAT proposal failed by roughly two thirds.

It was essentially unanimously agreed that VAT should utilize the invoice method and that the tax should be stated on the invoice rather than included in the purchase price.

By roughly two thirds margin it was agreed that VAT should be at a flat rate with no exceptions or exemptions in order to reduce the burden of administration and that other vehicles should be used to remedy any perceived inequities.

Proposition twelve regarding linking elimination of the corporate income tax was rejected unanimously.

TOPIC: Compensating Key Persons in Small Business with Stock or Stock Options

SUMMARY OF PROBLEM ADDRESSED: To attract and retain key employees, a small business will frequently desire to provide its key personnel with a "piece of the action." Under current law, however, if stock is awarded to an employee or is sold to him at a bargain price as compensation for services, the market value of the stock (or in the case of the bargain sale, the difference between the market price and the bargain price) will in many instances be taxable to the employee in the year of receipt or purchase at ordinary income rates. Moreover, resale restrictions imposed by federal and state securities laws often prevent the use of the stock to raise cash to pay the tax.

PROPOSED SOLUTIONS:*

I. The following stock option program is proposed as a preferred alternative to reinstitution of Section 422 qualified stock options for small business. Under the proposal, no tax will be imposed upon the grant or exercise of a "small business stock option." A small business stock option must meet the following criteria:

*See "Results of Plenary Session" under this topic to determine which proposals were adopted, amended or rejected.

A. The exercise price must be not less than the fair market value of the stock as of the date of grant.

B. The term of the option may not exceed ten years from the date of grant.

C. In order to obtain long-term capital gains treatment, the stock must be held for at least twelve months from the date of exercise of the option and must not be sold prior to three years from the date of grant of the option.

D. Options may be granted to any employee and irrespective of his ownership interest in the company.

E. The plan shall be available for use only by a "small business" as the same may be defined; such status to be determined as of the date of grant.

COMMENT: With respect to the provisions of subparagraph E, if an ownership limitation is to be imposed, it is recommended that such limitation shall not be less than twenty-five percent of the outstanding and issued stock, including stock subject to option.

II. The Internal Revenue Code should be amended to provide for a deferral of payment of tax until ultimate disposition of the stock, unless the employee otherwise elects, to enable a company to give an employee a stock ownership position without the current obligation to pay tax, subject to the provisions set forth below. The deferral will apply only to:

1. Stock of a "small business company";

2. Any employee holding not more than twenty-five percent of the company's outstanding stock (including options as outstanding stock).

The employee would have a tax basis equal to the amount paid for the stock. At the time the employee disposes of the stock in a taxable transaction, the employee would be taxed with respect to the amount received on the disposition as (a) ordinary income to the extent that the fair market value at the time of issue exceeded the consideration, if any, paid therefor; and (b) capital gain to the extent that the sale price exceeds the said fair market value at the date of issue. If the employee disposes of the stock in a non-taxable transaction, the employee will recognize ordinary income as described in (a) above.

III. The Internal Revenue Code should be amended to provide that an employee of a "Section 1244 company" who realizes ordinary income as a result of being granted an ownership position in the company (upon exercise of an option or otherwise) would receive the benefits of Section 1244 if the stock is subsequently sold at a price below his basis in the stock or if the stock becomes worthless.

GENERAL COMMENT:

The proposal for reinstitution of qualified stock options for application to small businesses was not approved based on the belief that the first proposal set forth above is much preferred and involves substantially the same concepts.

TOPIC: Compensating Key Persons in Small Business with Stock or Stock Options

RESULTS OF PLENARY SESSION

With respect to Proposal I:

(a) A proposed amendment to eliminate the "small business" limitation in the proposal was rejected.

(b) A proposed amendment was adopted to add to subparagraph A the following language: "If the stock subject to the option is not publicly traded and the exercise price of the option is at least as high as the book value it shall be presumed that the option price was fair market value."

(c) As amended Proposal I and the Comment thereto were approved.

Proposals II and III were adopted in the forms proposed.

TOPIC: Capital Gains Rollover

SUMMARY OF THE PROBLEM ADDRESSED: In order to encourage investment in small business, it is proposed that in certain transactions the tax now attributable to the sale of corporate stock, or the operating assets of partnerships and proprietorships, be deferred by transferring the cost (tax basis) of the stock or assets sold to stock or assets which may be purchased with the cash received upon sale. The tax arising from the sale would be deferred until the disposition of the replacement stock or asset.

PROPOSED SOLUTIONS:*

I. Deferral of capital gains taxes should be permitted on the sale of an interest in a qualifying small enterprise provided the following criteria are met:

1. A Qualifying Small Enterprise. An enterprise which (a) meets two out of the following three criteria:

(i) has total gross revenues in each of the two taxable years preceding the year of sale of $30,000,000 or less;

(ii) has 1,000 employees or less as of the date of sale;

(iii) has a net worth of $15,000,000 or less at the time of sale;

* See "Results of Plenary Session" under this topic to determine which proposals were adopted, amended or rejected.

or (b) is a small business investment company licensed pursuant to the Small Business Investment Act of 1958.

2. Qualifying Enterprise. All business enterprises including proprietorships, partnerships and corporations.

3. Holding Period. Each interest in a qualifying small enterprise must be held by the seller for a minimum of twelve months.

4. Reinvestment Requirements. The proceeds from the sale of the interest in a qualifying small enterprise must be reinvested in another qualifying small enterprise within 24 months from the time of sale.

5. Maximum Number of Deferrals. Unlimited.

6. Retiree Exemption. Notwithstanding the provisions of paragraph 4 above, an individual having attained the age of 55 years or more may sell an interest in one qualifying small enterprise held for a minimum of twelve months and defer the capital gains tax, provided the proceeds of such sale are reinvested in any business entity or entities within a period not to exceed 24 months.

II. This proposal is identical to proposal No. I except that any gain realized from the sale of any capital assets may qualify for the deferral of the capital gains tax, provided the proceeds of such sale are reinvested in a qualifying small enterprise within a period not to exceed 24 months from the date of sale.

III. As an alternative to the capital gains rollover, it is proposed that a long-term capital gain realized from the sale of an interest in a qualifying small enterprise shall be taxed pursuant to the following provisions:

a) 80% of the gain realized pursuant to such sale will be excluded from calculation of taxpayer's federal tax liability; and

b) 20% of such gain shall be included under the category of ordinary income for such taxpayer in calculating his federal tax liability.

TOPIC: Capital Gains Rollover

RESULTS OF PLENARY SESSION

Proposal I, dealing with small to small rollovers, having been amended to state that the interest being sold must have met the qualifying small enterprise test only at the time of acquisition, and having been further amended to include the concept of a "maximum cap" for the one time retiree exemption, passed by a wide margin Attempts to delete the retiree exemption in its entirety failed.

Proposal II, dealing with unlimited rollovers into qualifying small business enterprises, was not adopted. Attempts to expand the proposal to cover unlimited rollovers with respect to sales of interests in any business entity, failed to pass by a wide margin.

Proposal III, dealing with a reduction in the capital gains tax with respect to sales of interests in qualifying small business enterprises, having been amended to state that the interest being sold need only qualify at the time of acquisition, failed to pass by a narrow margin.

TOPIC: Small Business Participating Security

SUMMARY OF PROBLEM ADDRESSED:

Existing financial markets do not effectively provide most small businesses with sufficient capital to sustain and enhance their growth.

In particular, investors in small businesses merit an investment tax credit and other tax benefits.

PROPOSED SOLUTION:*

RESOLVED that the Internal Revenue Code be amended to provide an Investment Tax Credit for investment in securities (hereinafter referred to as Small Business Participating Securities) issued by small businesses (as defined) which provide for both a fixed rate of interest and a contingent rate of interest.

1. Such securities would include the following features:

A. A fixed interest rate to be taxed as ordinary income to the investor and deductible as an expense by the issuer.

B. A contingent interest to be taxed as a long-term capital gain to the investor and deductible as an expense by the issuer; such contingent interest to be a function of positive business performance (e.g. sales earnings, etc.) as negotiated by the issuer and the investor.

* See "Results of Plenary Session" under this topic to determine which proposals were adopted, amended or rejected.

2. An investor in such securities would receive the following tax benefits:

A. A credit against Federal income taxes equivalent to 10% of the proceeds of such securities with maturities of not less than 7 years, 6 2/3% with maturities of 5 to 7 years, and 3 1/3% with maturities of 3 to 5 years (comparable to the investment tax credit related to the purchase of certain productive assets).

B. The same tax treatment subject to the same limitations as provided under Section 1244 for losses incurred upon the deposition or worthlessness of the security.

3. For these purposes, a small business would be defined as one with a net worth of less than $6,000,000 or two year average net profit of less than $2,000,000, which are the present criteria for SBIC investments.

4. A small business could have no more than $1,000,000 in face amount of Small Business Participating Securities outstanding at any one time.

5. The provisions of the applicable Federal statutes regulating financial institutions should be amended to classify a Small Business Participating Security as an eligible investment.

63-769 O - 80 - 44

The committee considered and rejected any requirement that would have precluded a Small Business Participating Security from having an equity feature, so as to permit the small business to offer such an inducement to investors, if desirable.

TOPIC: Small Business Participating Security

RESULTS OF PLENARY SESSION: The proposal in the form presented was adopted with the understanding that the treatment of contingent interest as specified in the proposal is not intended to result in an adjustment to the tax basis of the securities.

TOPIC: Assisting Small Business in Coping with Inflation

SUMMARY OF PROBLEM ADDRESSED: The adverse effects of inflation are especially severe on small businesses. Inflation causes artificial increases in real value, which increases the paper profits of the business and results in higher income taxes. Businesses are often forced to borrow to replace assets or to restrict their growth due to the cash flow reductions caused by higher taxes and the spiralling costs of replacement assets.

PROPOSED SOLUTIONS:*

First: We recommend that the inventory rules be changed to provide for a simplified inventory system which will make available to small businesses the benefits now available to larger businesses which can afford to make complicated "LIFO" calculations.

The details necessary to implement this recommendation must be left for further study. We believe that an optional simplified inventory system should include:

* See "Results of Plenary Session" under this topic to determine which proposals were adopted, amended or rejected.

(1) A provision whereby businesses using the simplified inventory system would be permitted to automatically adopt existing "LIFO" methods on a basis similar to the present FIFO to LIFO switch or, subject to IRS approval, any other acceptable method.

(2) A limited number of government published indices which would be made available as an alternative to existing double extension calculations.

(3) A single inventory pool, where practical.

(4) The elimination of the need to conform financial reporting to tax reporting (so-called book/tax conformity).

Consideration should be given to limiting the availability for use of the simplified inventory system to businesses with inventories below a specified amount at the beginning of a taxable year.

Second: We recommend the adoption of a new graduated corporate income tax schedule as follows:

Taxable Income	Rate
0- - $ 25,000	15%
$ 25,000 - $ 50,000	20%
$ 50,000 - $100,000	30%
$100,000 - $150,000	40%
Over $150,000	46%

<u>Third</u>: We recommend the adjustment of the following fixed dollar amounts in the Internal Revenue Code:

Accumulated earnings credit	\$250,000
1244 ordinary deduction limit	\$100,000 (\$200,000 in event of a joint return)
Gift tax exclusion	\$12,000 (\$24,000 in event of a joint gift)

<u>Fourth</u>: We endorse the concept of simplification and of permitting the election of a more rapid recovery of investment in depreciable assets. A taxpayer could choose to deduct all or a portion of the cost recovery allowance in any given year. Any unused portion of the allowance could be carried forward indefinitely and deducted in future years. This is not an endorsement of any pending legislation before Congress.

TOPIC: Assisting Small Business in Coping with Inflation

RESULTS OF PLENARY SESSION:

All proposals were adopted without amendment.

As an alternative to the second proposed solution an amendment was offered to reduce the 46 percent income tax bracket to 44 percent, which amendment was defeated.

The drafting committee specifically advised the Conference that they had considered carefully and rejected on policy and theoretical grounds the concept of "indexing" to inflation various dollar amounts stated in the Code.

<u>TOPIC</u>: Tax Incentives for Innovation

<u>SUMMARY OF PROBLEM ADDRESSED</u>: The development and commercialization of new products and processes is important to the American economy, and small business has traditionally played a significant role in the overall innovative effort. However, small businesses frequently face impediments to innovation that are not equally shared by large companies, and there is increasing evidence that innovation by small business is declining. This topic addresses various proposals for encouraging small business innovation through the tax laws.

<u>PROPOSED SOLUTIONS</u>:*

<u>First</u>: That the capital gains tax be reduced or eliminated.

<u>Second</u>: That Subchapter S be amended to allow corporations formed under the Subchapter not to exceed 100 shareholders, and further that such shareholders may be corporations, partnerships, or trusts.

<u>Third</u>: That the net operating loss carry forward for business enterprises be allowed as a deduction for an unlimited period.

* See "Results of Plenary Session" under this topic to determine which proposals were adopted, amended or rejected.

<u>Fourth</u>: That the definition of "patent holder" in Section 1235 of the Internal Revenue Code be revised to include any individual or entity.

<u>Fifth</u>: That Section 1235 of the Code be amended to permit, within its scope, transfers of patent rights with field of use or geographic restrictions.

TOPIC: Tax Incentive for Innovation

RESULTS OF PLENARY SESSION: All proposals were adopted with the following amendments:

1. The words "or eliminated" were deleted from the first proposal.

2. The words "for business operations" were deleted from the third proposal and the words "Section 172" were inserted before the words "net operating loss" in that proposal.

TOPIC: Reserve for Market Makers

SUMMARY OF PROBLEM ADDRESSED: The limited liquidity of investments in small business securities operates as a major disincentive to small business capital formation.

PROPOSED SOLUTION:* RESOLVED, that this Conference supports the concept of the reserve for market makers as a solution to the problem of small business securities liquidity, and that since this concept as embodied in S. 1967 would assist in adding to the depth and liquidity of issues of small business securities and in the financing thereof, this Conference supports the adoption of S. 1967. In addition, this Conference urges Congress to consider the following modifications to S. 1967:

1. Extend the availability of the deferral to non-corporate as well as corporate broker-dealers.

2. Extend the categories of securities which would be subject to the deferral to include debt securities convertible to equity as well as equity securities.

3. Require mandatory withdrawal of the entire reserve when market making activities cease.

* See "Results of Plenary Session" under this topic to determine which proposals were adopted, amended or rejected.

<u>TOPIC</u>: Reserve for Market Makers

<u>RESULTS OF PLENARY SESSION</u>: The resolution endorsing the establishment of the reserve for market makers was adopted without amendment by the voice vote of participants.

TESTIMONY

by

DEAN A. TREPTOW

President - Independent Business Association of Wisconsin

Chairman - Wisconsin Delegation to White House Conference on Small Business

President - Brown Deer Bank

HEARING BEFORE:

U. S. Senate Committee on Finance

April 1, 1980

The ten highest priority recommendations of the White House Conference on Small Business included 5 recommendations for tax reform and a directive to balance the Federal budget by fiscal 1981, restricting the size of that budget to a percentage of GNP. The tax reform measures all came from the sessions on Capital Formation. The balanced budget recommendation was created in the sessions on Inflation. The most popular recommendation, receiving support from 86% of the delegates, called for reduction of corporate and personal income taxes. A balanced federal budget was ranked third in priority, receiving endorsement from 62% of the delegates. The initial response from many individuals in Congress and the Administration is that there is an obvious conflict between these recommendations, citing the difficulties in simultaneously reducing taxes and balancing the federal budget.

It is my judgment that there need not be conflict. First, you should know that the delegates to the White House Conference worked with a perspective of policy development for the next decade. They recognized that all of their recommendations would not and could not be implemented immediately. With regard to inflation, however, they believed that there was a compelling urgency and set a time frame for accomplishment of their most important anti-inflation measure - balance the 1981 budget. You will also be interested to know that when delegates chose reduction of corporate income taxes through graduation of rates up to $500,000 of income, they specifically vetoed a rider to that recommendation that would have indexed the graduated brackets to inflation. They vetoed indexing because they believed that indexing would imply that they were consenting to the institutionalization of inflation and giving up the fight. They made this decision with the clear understanding that the benefits of graduation to $500,000 would soon be wiped out if our current rate of inflation was not drastically reduced.

These examples, I believe, clearly reveal the order of priority for small business. It should not be construed, however, that small business is complacent about its capital formation needs. It is believed that continued high rates of inflation will defeat any measures to improve capital formation and retention in this country. The balanced budget is the focal point for fighting inflation because deficit spending symbolizes a public policy devoted to consumption rather than productive efficiency. Continued deficit spending is a statement that we have decreasing confidence in the private sector to meet our national socio-economic goals.

Clearly, the fight against inflation and the small business recommendations for capital formation and retention cannot be separated. The 1978 Tax Reform Act gave incorporated small business an income tax break by graduating income taxes up to $100,000 of income and reduced the rate on all corporate income over $100,000 from 48% to 46%. Let's take the example of a manufacturer that had sales of $3,000,000 in 1978. Now let's assume that the manufacturer sold exactly the same number of units of product in 1979 as in 1978, however inflation increased costs and the manufacturer was able to increase sales prices by 15%. That means that sales volume in 1979 was $3,450,000 with no increase in units sold. Now let's assume that in both years the company was able to collect its accounts receivable in 45 days from date of billing and maintained inventories for 90 days of operation. The 15% inflation would result in an increase of accounts receivable from $370,000 to $425,000. Inventories would have increased from $518,000 to $596,000. This represents an increased working capital requirement of $133,000. If the company borrowed that money from a bank at an average cost of 15%, the interest expense would have been $20,000 or over twice the tax savings resulting from the 1978 Tax Reform Act. You can readily extrapolate the effect of current conditions with inflation close to a 20% annualized rate and the prime rate at 19½%.

How did the federal government fare in this example. If we assume the corporate income prior to interest expense and taxes in both years was 10% of sales, then taxes in 1978 would have been $130,500. In 1979, applying the reduced income taxes rates after deducting the interest expense, federal income taxes would have been $130,250. The government, thanks to inflation, recovered all but $250.00 of a tax cut that should have been $11,900 in constant dollars. Thanks to inflation, there was no capital formation in the 1978 Tax Reform Act.

We can carry this example further. Banks lend money based on ability to repay. During 1979 this company borrowed $133,000 in order to manufacture and sell the same number of units that it did the previous year. After paying its interest bill, net after taxes increased by $25,250. If inflation remained at the same 15% rate in the future, the company would be running further in debt at the rate of over $100,000 per year. This is a road to bankruptcy and obviously no bank will continue lending at that pace. What does the company do? It can try to collect its receivables faster and cut back inventories. This works until the receivables and inventory are cut back to absolute minimums, then the rate of debt increase resumes again. The only salvation from going out of business is to increase prices at a rate faster than the 15% inflation rate. That, of course, can only contribute to greater inflation and the problem is never solved. Don't forget, we never considered the financial consequences if this company had decided that it wanted to

63-769 O - 80 - 45

produce more units, which would produce more jobs. What about funding some applied research for a significant product improvement? Would the company dare to ask a lender for $100,000 to purchase a new machine tool that could greatly enhance productivity. Suppose this small manufacturer couldn't increase his prices fast enough. Perhaps he would sell out to a conglomerate with enough market control to pass through costs to consumers.

Senator Gaylord Nelson has stated that everyone on Capitol Hill respects the importance of small business to our country. I'm convinced this is true. I don't believe, however, that many people are convinced of the desperate urgency for improvement in capital formation and retention for small business. The recommendations of the White House Conference on Small Business address this need. Even if we reduce inflation to half or one third of its present rate, the survival of small business needs these capital enhancing vehicles. If we don't reduce inflation, the capital formation issues are largely academic. You couldn't cut taxes fast enough to save a majority of the 14 million small businesses in this country.

America's small business people believe we must all make the necessary sacrifices and eliminate deficit spending with the 1981 budget. That action can be the beginning of a new economic era if it is followed with a tax policy that encourages savings and investment in this country.

Our tax policies today have characteristics of a 19th century populism geared to a two class society. Capital is regarded as wealth with its only value lying in its ability to be redistributed by government for consumption. Income derived from investment, whether in bank savings or in business capital, is characterized as "unearned income" and subjected to higher maximum tax rates. Borrow for purely consumptive purposes and you get a tax deduction. Tax laws combined with banking regulations on savings interest have resulted in savers subsidizing borrowers for years. The thousands of independent banks like mine in this country are extremely important in meeting the financing needs of small business. We rely on the savings of blue collar, white collar and retired persons to fund these loans. Current economic conditions and tax policies have almost destroyed the desire and ability of these people to save.

We need to value Capital as a vital resource in the means of production. Capital employed in funding research on product improvement, technological development and supporting jobs is improving productivity. We need to be more concerned with application of capital than the ownership of capital in our tax policies. Small business has created most of the new jobs in this country in the last decade. It has been a leader in innovation and healthy competition.

Our tax policies should reflect the value of investment in these enterprises. It is ~~the most~~ efficient, direct means of meeting our national goals for quality of life for all. The recommendations of the White House Conference on Small Business address this need.

During the course of this hearing you will receive many recommendations for improving the future of small business. You will also be evaluating economic policies. I would like you to consider several characteristics of small business that I believe can be important in your deliberations.

SOURCES OF CAPITAL

Most small businesses are founded on the savings of their owners and close friends or relatives of the owners. This initial capital serves to get the business started and establish a track record. Future growth is usually funded with retained earnings and bank loans. The ability to retain after tax earnings is really the foundation of growth, because available bank credit is necessarily a multiple of earnings potential of a business. Tax impact is extremely important as a governing factor in business growth. In a well managed, growing business, each dollar of after tax earnings may permit $4-5.00 of bank term credit.

GOVERNMENT LOAN GUARANTEES

These programs were usually founded to assist small business in securing credit when they couldn't meet the normal credit qualification standards of private lenders. In the last few years, a far more important objective for these loan guarantees has developed. Thanks to the development of a secondary market for S.B.A. and Farmers Home Administration guaranteed loans, banks have been securing these guarantees on loans that are of excellent credit quality, the reason being that the bank can sell those loans to large institutional investors and thereby tap a source of funds other than its own deposits and capital. To the small business this has represented an opportunity to tap the public debt markets for the first time.

When you are considering various means of cutting federal expenses in attempting to balance the budget, I ask you to consider this new importance of loan guarantee programs. Tightening credit standards for issuance of the guarantees will eliminate government expense under the programs, while preserving the credit availability features of the secondary market for the stronger companies. This vehicle is exceptionally important at this point in the economic cycle when banks are experiencing deposit erosion and reduced liquidity.

CONCENTRATION OF CAPITAL

The current inflationary period is resulting in the customary disintermediation of funds from small business' principal source - the banking system. The government is extracting huge sums of money from the private sector with interest rates over 15%. The relatively new entity, the money market mutual fund has attracted close to $90 billion. Those funds have come largely from the banks and thrift institutions. The effect has been to pull these funds from community financial institutions and concentrate them in relatively few money market institutions. The bulk of the money market funds have been re-invested in U. S. Government securities and C.D.'s of the nation's largest banks. A very small portion, if any, of this $90 billion is finding its way back to small business. These money market funds are attractive because they are free of regulation that restricts banks from offering comparable advantages. This situation is not unlike permitting Ford Motor Co. to operate without any of the safety and environmental regulations while retaining those regulations for all other auto companies.

Senator BYRD. We have one more panel.

Mr. Mike McKevitte, National Federation of Independent Businesses—incidentally, he has done an outstanding job for that organization; and Mr. Arthur Little, president, National Association of Small Business Investment Co's; and Mr. Dwane Pearsall, president, Small Business Development Corp. of Golden, Colo., had planned to be on the earlier panel but was delayed, so we the committee will hear from him along with the other members of this panel.

Senator CHAFEE. Mr. Chairman, I just want to introduce to you Mr. Arthur D. Little, who is from Rhode Island, an eminent businessman there and very familiar with the problems of small business investment companies and I just wanted to say to Mr. Little, we are delighted that you came down today and appreciate your taking the time.

Mr. LITTLE. Thank you, Senator.

Senator BYRD. I am glad you mentioned Mr. Little, Senator Chafee. I do not have the privilege of knowing him well personally, but I do know well of his company and the great reputation that he has in this line of endeavor.

Welcome to each of you.

Who wishes to proceed first?

Mr. LITTLE. I will go first, Senator.

STATEMENT OF ARTHUR D. LITTLE, PRESIDENT NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

Mr. LITTLE. I am Arthur D. Little, president of Narragansett Capital Corp. We are the largest publicly-held small business investment company in the country.

This year I am also privileged to serve as the president of the National Association of Small Business Investment Cos., I would like to mention that with me here today is Alan Kaupinen of Inverness Capital Corp., which is located in Alexandria, Va.

I assume, if I may, that my written remarks will be a part of the record.

Senator BYRD. Yes, they will be made a part of the record and you could brief them as you thought best.

Mr. LITTLE. I thought much of what I have in my written statement has already been covered by some of the previous witnesses and, as a result, I will depart from those written statements somewhat.

I think, just as a general comment on what we have already heard this morning, I think certainly for the health of the Nation in general and small business in particular that the control of inflation is extraordinarily important and perhaps preeminent is a better word.

Senator BYRD. If you would let me interrupt you for a moment, I think it should receive the top priority of any aspect of our thinking in Washington today and I am faced with a dilemma in that regard, I might say. I may have to leave here before this panel concludes, and if I do, I will ask Senator Chafee if he would be willing to preside.

The Armed Services Committee is now considering defense spending and we have two supreme priorities, as I see it. One is national defense and the other is inflation. And I do not think we can have a strong defense unless we have a strong economy. We have to be soundly based financially, our Government does, and it is very difficult to know which to give the higher priority to.

At the moment I think the conditions in our country are such that the highest priority should be given to getting inflation under control.

Proceed, Mr. Little.

Mr. LITTLE. In regard to Senator Baucus' comments relative to inflation and investment, or capital retention and investment, I think the two work hand in hand. We see it particularly in our company in that we take a look at the rate of return that we would hope to get on the returns that we invest. And needless to say, when you are looking at being able to invest, we do have some investments of this nature in CD's which bring us a rate of 18 percent as opposed to a few years ago when we were looking at something more on a 6- to 7-percent rate.

I think you can see when you lay that kind of investment next to an investment in a small business it makes the necessary rate of return in the small business go that much higher.

Now, one of the only ways in which a small business is going to be able to get that kind of higher rate of return is to charge higher prices to its customers and you know, you get into this terrible vicious circle.

I think there are two things that really have to be done. One is to bring inflation under control and two, to have a program over a period of time to promote capital formation and retention.

I really look at capital retention as being part of formation. I think that you said earlier not to come up here with wish lists and indeed, when I look at the length of the list of the things that we feel are very important, it is quite a long list; and as I look over the summary on the front of our testimony, I see that there are a number of items on which I have testified recently. And a number of them, of Senator Nelson, which are not on that list as well. So it could be even longer.

I think the thing that you have to realize is that we are, as previous witnesses said, really looking for a program over a period of time to get this situation back in balance.

The second point is that we feel that at the moment we have gone so far away from what really made this country strong economically, and that is one of the reasons that the list is so long. We have gone a long way and we have got a long way to go back.

I just would like to outline, or hit in highlight form some of the specific items that we feel are very important and then I would like to let Alan, on my right, describe what we feel is the most important of NASBIC's programs for the year.

I think the central message that we would like to hit on is that we must make it a policy decision for the country to support capital formation for small businesses in every way possible.

It is small businesses which are the innovators in terms of high technology products, in terms of the things that are going to bring us increased productivity. They are, in my mind, the toughest competitors and also the real job creators.

I am sure you are all aware of the fact that small business is really what creates jobs in this country. Unfortunately, the other group that really creates jobs about half as fast as small business is Government. Big business, in general, does not create a great deal of new employment.

So independent, small and growing firms are the new blood in our economy which really reinvigorate our entire system.

I would just like to put in a plug at this point for the SBIC industry, which I think has been one of the biggest, greatest returns for the Federal Government. I do not know any more productive partnership between the private sector and the Government than the SBIC program.

Again, in my written testimony, you will find cited various studies over the years by MIT, the American Electronics Association, et cetera, which will really show what kind of return in terms of jobs and innovation and tax revenues are brought to the Nation by smaller businesses, and which rebut the inevitable arguments of the Treasury Department that tax incentives for investing in smaller businesses will create revenue losses.

The recent American Electronics Association study shows a 30-percent yearly—that is a cumulative 30-percent yearly—rate of return to the Federal Government on venture dollars that are invested in smaller businesses.

Our own trade association last year undertook a study. You will find, I think, what I believe to be some extremely impressive figures that we have included in the written testimony.

I think it must be obvious from listening to the testimony this morning that small businesses really are relying, even the very profitable ones, on externally generated investment in order to grow. It appears that the figure is about 70 percent that they are relying on external factors.

In other words, only 30 percent of the growth capital that they get comes from internally-generated funds.

Well, what is the result of that? The result is a number of things.

One thing is that—and here are some figures that a question came from earlier—the Federal Trade Commission reported that during the period 1972 to 1977, 75 percent of all mergers were between very small companies with assets of less than $1 million, and large companies, 42 percent of which had assets in excess of $100 million.

Senator BYRD. Excuse me. May I interrupt you at that point? That indicates that the very larger companies are—I do not suppose this is the right word to use, but I will use it anyway—gobbling up the small companies. Is that it?

Mr. LITTLE. Well, it does, but the question is, what choice do the smaller companies have? We have already touched this morning on estate problems, on liquidity problems, on the problems that smaller businesses have, because if they really are small and they are growing very rapidly they need a tremendous amount of capital and they cannot get it from the public markets and they cannot get it from private placements, and so where do they have to go? They have to go to a big business in order to get the capital that they need to grow.

Senator BYRD. That is something that the Congress should be aware of, which I do not think it is, and No. 2, should take reasonable steps to do something about, and that is the purport of your testimony today, as I understand it.

Mr. LITTLE. Well, I hope to get around to suggesting a couple of solutions to that problem.

If you will look on the very front page of our testimony, we have put on there some recommended tax changes and certainly our top priority, as I mentioned, is the capital gains rollover which Alan will cover in a few minutes.

Second, we did not, I notice, but this list in what I would consider to be the order of priority, but certainly graduating the corporate income tax up to the $500,000 level so that you are increasing the surtax exemption is probably the next most important thing. Adopting a simplified and more rapid depreciation system is certainly important.

And I think one of the ideas that was hit on briefly here this morning that is extremely important and very innovative is this small business participating debenture. I think that that is an idea whose time has really come and I think the interesting thing about that is that there are lots of smaller businesses out there that want to remain independent. If they are being approached by people like ourselves, for instance, saying we want to make an investment in your business, they say gee, we really do not want to sell you equity on a permanent basis. We would like to sell you a part of the profits, but we do not want to give up our real independence.

The small business participating debenture is a way for those people to get their financing, for us to get some capital gains treatment out of it, and in general for these companies to get financing that might not otherwise be available.

I think if you just look at the rest of our list of suggestions, you will find most of them familiar to you.

Now, I would just like to turn it over to Alan who will talk about the rollover for a few minutes.

STATEMENT OF ALAN G. KAUPINEN, INVERNESS CAPITAL CORP., ALEXANDRIA, VA.

Mr. KAUPINEN. Senator Byrd, Senator Chafee, it is a pleasure for me to have this opportunity to appear before your committee today. I represent Inverness Capital Corp., which is a small business investment company—an SBIC—located in Alexandria, Va.

We have 49 investments in small concerns of which many are local to our immediate capital region here.

As Arthur said, I want to make some comments regarding the rollover and to do that, I would first start by discussing some of the various concepts of a rollover.

One rollover would allow a capital gain realized in a small business to be rolled over into anything. While this would be very desirable for owners and investors in small businesses, we feel that such a concept will not target the capital formation needs of small business because it would allow by allowing gains to be rolled out of small companies and into less risky, larger investments—as an example, Government securities or Fortune 500 equities. As several people have commented today, this is certainly not the direction that it appears that anyone desires to go in.

Another type of rollover would——

Senator CHAFEE. Excuse me. I was diverted there for a minute. You are advocating the rollover from one small business to another small business.

Mr. KAUPINEN. Right.

Senator CHAFEE. You are not advocating a tax-free rollover from a small business into a big listed company of some type?

Mr. KAUPINEN. No. As a matter of fact, we believe very strongly that that is not desirable because it heads us in the exact direction that we do not want to go.

We, of course, as has been expressed here by you all earlier, desire to strengthen small business and certainly one of the ways to avoid that is to give incentives to roll these gains into a Fortune 500 company or other less risky securities.

Senator CHAFEE. All right. Go ahead.

Mr. KAUPINEN. Thank you.

Another type of rollover would allow a gain realized on any investment to be rolled over if reinvested in a small business. Such a provision would certainly attract a great amount of capital.

Another concept would establish investment accounts in which individuals could invest in anything and all income accruing to that account, be it a capital gain or dividends or interest, would be rolled over. In other words, the tax would be deferred until such income were withdrawn from the special accounts.

Now, our comment on that is that it is a worthy proposal but we do not feel that it, alone, would provide the flow of new venture and equity dollars in small companies that is currently needed.

Since most venture capital today is invested by institutions, a rollover account directed toward individuals would be of little help. Certainly, some individuals will invest in small and private companies, but the practice would not, in our estimation, be widespread.

Indeed, the securities laws currently limit participations of individual investments in small, private companies so that even if syndications of individuals were put together they would be relatively limited in number.

We therefore strongly recommend that any rollover provision which is introduced into law by the Congress be expanded to include institutional investors, particularly SBIC's like ourselves, which currently by law must reinvest all proceeds from gains into new and growing small businesses.

While venture capital benefited greatly from the capital gains tax reductions of 1978, much more is needed in this area. Additionally, most of that venture capital has flowed into limited partnerships which are created for a specific purpose and usually have a limited life of approximately 10 years.

That partnership popularity flows from the fact that the 1978 capital gains tax change signaled a major reduction for individual capital gains, thereby making the partnership vehicle more attractive.

The corporate venture capital vehicle is still much in need of tax incentives.

A fourth type of rollover covers the situation where the proceeds of sales of securities issued by businesses when they were small are reinvested in other small businesses. We feel that such a rollover is equitable, fairly balanced against other public policy goals, would be easy to administer, and potentially very helpful to the small business community.

Our association, the National Association for Small Business Investment Companies, of which Arthur Little is the president, strongly supports the rollover introduced by Senator Gaylord Nelson and cosponsored by Senator Baucus.

Senator CHAFEE. Mr. Kaupinen, we are running short of time here. I have followed this through now. You do support the S. 653.

Mr. KAUPINEN. Very strongly.

Senator CHAFEE. This is a good document which you and Mr. Little have submitted so we have got your other thoughts here. I think that about completes the rollover part, does it not?

Mr. KAUPINEN. Yes, sir.

As the statement is prepared, it has all of our positions on the rollover in it.

Senator CHAFEE. Good.

Let me ask Mr. Little, the revised estate tax laws to ease burdens in family-owned businesses, your item No. 7, I do not think you touch on that in your statement, do you?

Mr. LITTLE. No, I really do not, and I must confess that that is not one of my great areas of expertise either. Just as a basic thought, though, we feel that the way that the estate tax laws are now, it really forces people to sell businesses at times when that might not be the most appropriate thing for them to do.

Senator CHAFEE. I think there is an association of family-owned businesses that has presented material on that and I think that they have an act before us. Let me just say, I have great problems with a specialized act of that nature.

We have had similar acts come in on ownership of family newspapers, for example, and you always get into great difficulty where you draw the line, if you do it for a newspaper, then you do it for a family farm, and you do it for a family-owned small business and I think that is going pretty far astray, certainly from the limited objectives we are looking toward here, which are not necessarily preservation of small business. They are the encouragement of small business, the thrust of this committee.

Mr. LITTLE. Looking at it slightly from the other side, Senator, I think you have to look at the things that, apart from encouraging small business, specifically drive people out of small business situations; because it very well might be that if you do not do something for the family-owned business, and indeed, some of these other measures are going to help some of those businesses, they may have really no other choice but to sell out in a stock-for-stock transaction with a larger company.

Senator CHAFEE. I think the point you make is a good one. There is more than just encouragement. We want to keep them going once they are there.

So you are right. I should not have dismissed this so out of hand. But it is a complicated field, that No. 7. I think you would find us somewhat reluctant to get into it.

Mr. LITTLE. I am afraid they are all complicated fields these days.

Senator CHAFEE. Well, some of them are easier than others. Why do we not take Mr. McKevitt now.

Does that complete your testimony, Mr. Little?

Mr. LITTLE. Yes, thank you, sir.

Senator CHAFEE. Mr. McKevitt?

Mr. MOTLEY. Senator Chafee, I am John Motley, the deputy director for Federal legislation——

Senator CHAFEE. Also from Rhode Island?

Mr. MOTLEY. Definitely.

Senator CHAFEE. Well, you start ahead of the game.

Mr. MOTLEY. Thank you.

Mr. McKevitt sends his regrets. He was unavoidably called away from the office this morning and wants me to give the testimony on his behalf.

Senator CHAFEE. Fine. I think he has a written statement?

Mr. MOTLEY. We have a written statement which we would like to submit for the record and then, if I may go through and summarize parts of it and also possibly read certain other parts of it that I would like to emphasize.

Capital retention is an important part of the small business capital formation process.

Senator CHAFEE. Now, it is quite a lengthy statement here, Mr. Motley. I think perhaps if you could summarize it, that would be good.

Mr. MOTLEY. I definitely will, Mr. Chairman. Thank you.

STATEMENT OF JOHN J. MOTLEY III, NATIONAL FEDERATION OF INDEPENDENT BUSINESSMEN

Mr. MOTLEY. While investor financing is available and desired by some small firms, it is and will always be atypical. Capital retention and bank loans are the two normal methods of financing smaller businesses. Since bank loans are generally contingent, directly or indirectly, on earnings of a small business, the ability of a small business to retain capital is particularly vital to its operations.

Mr. Chairman I think you will find that NFIB's priorities differ somewhat from those that you may have heard during these hearings so far. Our priorities definitely are also different from those of the White House Conference on Small Business in the areas of capital formation and retention.

I am sure that the first question that would come to your mind and several others is why did they differ from the priorities set, especially by the White House Conference?

The reason we believe that they differ is that, in taking a look at the demography of the delegates who attended the White House Conference, I think you will find that they tended to be larger small businesses, more successful small businesses, more capital-intensive small businesses, and very heavily corporate small businesses, when just the opposite is true if you take a look at the small business community as a whole.

That tends to be dominated by unincorporated businesses, proprietorships and partnerships.

NFIB's priorities in the area of capital formation and retention are directly related to the number of firms that these changes in the code will help. This does not mean we do not support the recommendations of the White House Conference on Small Business or that we do not support the tax reduction bills that have been introduced by Senator Nelson and other Senators before this committee.

What it does mean is that NFIB supports most strongly those changes that have a beneficial impact on the greatest number of small firms.

These would include, but are certainly not limited to, a reduction in payroll taxes as a part of overall reform of social security and unemployment compensation programs; depreciation reform, in particular the Capital Costs Recovery Act of 1979, a bill which is commonly referred to as 10-5-3 which we helped to draft.

Third would be inventory reform, or a simplification of the last in, first out inventory method and allowing smaller firms to use the cash method of accounting.

And the last of those that I will mention, but certainly not the least, is a reduction in corporate taxes, specifically an increase in the corporate surtax exemption and further graduation and also a reduction in individual taxes to help unincorporated firms.

In the interests of time I would like to concentrate pretty much on two of these areas if I can, primarily on the area of payroll taxes and then, if there is any time leftover, I would like to say a few words about inventory accounting, since I do not think that either of these areas have been covered in depth by other witnesses.

Switching to page 3 of my prepared text now, Mr. Chairman, I would like to read some of the figures here. Payroll taxes, of the various forms of direct taxes paid by small business, payroll taxes are the costliest to a majority of firms.

Small businesses paid a conservatively estimated $28 billion in total payroll taxes in 1979. This figure amounted to roughly 41 percent of the total paid in by private sector employers.

An estimated $22.5 billion alone was paid by the small business sector in social security taxes.

Given that total FICA taxes paid in by private employers was roughly $53 billion in 1979, small business accounted for an absolute minimum of 37 percent of the total private sector employee payroll tax contributions.

Despite the existing level of payroll taxes, higher and higher levels are anticipated. The Social Security Financing Act of 1977 raised tax rates from 5.85 percent to 7.15 percent and the wage base from $16,600 to $42,600 over a 10-year period. Even that will not be adequate to cover legislated benefits.

We already have a temporary cash flow problem in the OASI fund which some feel may not be covered by borrowing from other funds. We base a conservatively estimated $632 billion long-term shortfall in OASI alone and tax rates possibly doubling those today.

And that is only social security. States like Pennsylvnaia are discussing increased unemployment compensation taxes to repay the Federal Government for loans received during the last recession. Another recession will surely add to pressures in several

States to maintain, if not add, payroll taxes to cover unemployment compensation costs.

Finally, the Congress is discussing a National Health Insurance program. While the proposals are many and varied, at least some consideration has been given to financing national health insurance through direct payroll taxes.

As a result, the payroll tax burden that small business faces not only is one of coping with existing levels, but of averting extraordinary increases.

Payroll tax effects on business starts. It is clear small business has been the sector primarily responsibile for the incredible increase in the number of net new jobs over the past decade. David Birch at MIT has estimated that between 1969 and 1976, two-thirds of the Nation's net new private sector employment came in firms employing 20 or fewer people; 80 percent came in firms employing 100 or less.

While these data have been generally recognized and often publicized, Birch's second major finding is overlooked.

He notes that employment loss due to business failure is virtually constant throughout the country. Migration is of virtually no consequence.

The net gains in employment result from the number of new business starts and the expansion they undergo in their first 4 years of operation. Thus, it is the new expanding business which has had such an important and positive effect on employment.

The majority of the Nation's technological innovations also came from small business. These are often new, rapidly growing firms.

Without them, our dismal productivity record over the past decade would be even worse. But the evidence is that the number of new, innovative firms has been decreasing, largely due to a lack of capital.

It is an understatement to note the vulnerability of new, small businesses. Typically the new entrepreneur is inexperienced, woefully underfinanced, and can expect an initial period of unprofitability.

For example, 9 out of 10 have not owned and operated a business previously, while a majority of new entrepreneurs have had some type of management or marketing experience working for others prior to entry, running the entire operation from finance to personnel is considerably different.

Further, 60 percent of the people starting their own business have, as their major source of financing, personal resources. Virtually every type of new business venture is heavily dependent on personal resources of the owner. This generally means a pinch on cash flow, negligible capital for business investment, and absolutely no nonessential personal expenditures.

Not surprisingly, the turnover rate is very high.

The impact of payroll taxes on such firms is particularly onerous. It raises the fixed costs of doing business exactly when the business is most vulnerable and most in need of capital.

With taxes levied on employees, the entrepreneur's tax is not related to income, financial health of the business, or anything of that nature.

Obviously, existing payroll taxes are regressive for both employers and employees but in a very real sense, payroll taxes are more regressive for new entrepreneurs than for any other group.

The payroll tax levied on employees at least bears some relationship to their earnings. That is not true with the new entrepreneurs. In fact, quite the opposite appears to be occurring.

While regretably no data exists to support or refute our observations, it appears that because a new venture tends to be undercapitalized, the labor-capital mix is heavily tilted toward labor and will continue to be until such time as the business is sufficiently profitable to begin substituting capital.

Thus, the taxes paid on labor bear most heavily on the new entrepreneur.

Second, because the new venture is so frequently undercapitalized, the wages paid to employees tend to be lower than in comparable firms of greater longevity. That means a larger percentage of payroll will be subject to taxation.

Remember, both FICA and unemployment have wage bases. Once those bases are exceeded, no tax is levied.

Thus, as a general rule, the greater the range of wages paid and the higher the wages paid, the lower the tax as a percent of payroll.

Third, unemployment——

Senator CHAFEE. Now Mr. Motley, we have got to move on here, I regret to say, because I have to go shortly and we want to hear from Mr. Pearsall.

I get your point here on the unemployment compensation, the experience rating and down here on the bottom of page 5.

Let's get to your solutions.

Mr. MOTLEY. Solutions are extremely difficult to come up with in the area of payroll taxes, Mr. Chairman. NFIB over the last 18 months has invested a great deal of time, money, and effort to try and work with Dr. Michael Boskin at Stanford University and a team of economists he has been working with to come up with a reform of the social security program.

We believe that the only way to approach this is to try and do away with the present bifurcated system which tends to address both the social need and the retirement need and very shortly we will be presenting to this committee and to the Congress the results of Dr. Boskin's research.

Senator CHAFEE. You are talking about the disability section?

Mr. MOTLEY. About social security.

Senator CHAFEE. Yes, but the disability side of it?

Mr. MOTLEY. We are talking about the entire program. Disability, HI, and OASI.

As far as unemployment compensation is concerned, Senator Boren has been having hearings in his subcommittee which is taking a look at the problem and we strongly recommend, based upon the research of several professors out at George Mason University that we take a look at the impact of experience ratings on small firms and possibly try to reform the program from that aspect.

Let me move on, if I can, just to make a few comments about inventory accounting. If you take a look at the small business community, you can see very readily that the majority of it is concentrated in the retail sector. Since this is true, the impact of inventory is great in that area.

In inflationary times, present accounting rules which are allowed by IRS have a tremendous impact on those small firms.

We would like to make the point that just as the present depreciation code is tremendously inequitable to small firms because of its complexity, so also is the present rules governing accounting procedures.

We would like to suggest that the committee consider moving to cash accounting for small retailers, say under $2 million or $1 million a year in gross sales, giving them similar treatment to that given the small farmers under $1 million in gross sales today.

We believe that this would be a tremendous simplification that would help small retailers and small wholesalers across this country.

I think that about concludes the points that I would like to make, Mr. Chairman. Thank you very much and I will try to answer any questions that you might have.

Senator CHAFEE. Well, thank you. I think you have brought to us something original here that we have not given thought to before and indeed, have not had raised with us, this cash method of accounting for the smaller firms.

As you pointed out, quite rightly, that most of the small businesses that we see are capital intensive. They are not the merchandisers. They are the manufacturers. And thus the whole thrust, as you have heard this morning, has been on capital cost recovery which many of your members do not have a problem with because they are not that capital intensive.

Mr. MOTLEY. 10 percent of NFIB's membership is manufacturers, which means roughly about 60,000 of them, and it is a tremendous problem and we did help to draft the present 10-5-3 proposal. We support it very strongly.

But we believe if we are looking for things to help the entire small business community, you must be aware that it is a tremendously diverse group out there and no one proposal will help everybody.

Senator CHAFEE. All right. Why do we not go ahead, thank you very much, Mr. Motley. Let's go ahead with Mr. Pearsall.

STATEMENT OF DUANE PEARSALL, PRESIDENT, SMALL BUSINESS DEVELOPMENT CORP., GOLDEN, COLO.

Mr. PEARSALL. I have no constituency to represent. I am a small businessman from Denver, Colo. I will only make a couple of comments that really are of deep concern to me and submit the balance of the report for the record.

I want to call the committee's attention to the 1977 Casey Report. That was a Venture and Equity Capital Task Force of SBA. A statistic came out of that study which did not get into print, and which to me summarizes what our problem is today in the small business community.

That problem is that total invested capital in small business, now speaking of those under $50 million in gross revenues, equalled 3.1 times the total capital invested in businesses over $1 billion in gross revenues in 1956. In 20 years, that total capital relationship had eroded. In 1975 it was only 77 percent of that invested in small business.

To me, that is a dramatic statistic that I have not seen in print anywhere and I have not had it verified, but it came out of the research group serving that Casey Report committee.

I apologize for not being here earlier. I had a testimony at the House Small Business Committee this morning, and unfortunately, they are not as diligent as you. They didn't start until 10 o'clock. Let me quote from Milt Stewart's report to a Denver conference in 1979. Perhaps this has already been entered, but I will abbreviate it.

This is quoting 1974 figures, considering total taxes to include Federal, State, local, social security, unemployment, insurance and income. "It is reported that manufacturing firms of $50,000 to $100,000 in gross receipts, comparing total taxes as a percentage of net worth, was 30 percent."

Figures then are regressive. As the business gets larger, the tax burden relative to net worth gets smaller, until when you reach over $1 billion, the tax burden is as low as 11.5 percent. To me that is an appalling statistic.

One thing that Milt Stewart has said is that "it is time to recognize we can't continue doing 'small' things for small business," and hope to preserve the basic foundation of our economy, which I think is small business.

My other main concern is interest rates. I have had a small business, an innovative business, which grew and was succesful, and we sold to a major corporation. Having sold, I became the president of a division and participated in big business corporate planning.

I can tell you that they have been planning for a recession, as any reasonably run big business has been planning for the past couple of years. They are not going to feel it in their financial statement if it lasts less than a year.

However, I have yet to see a small business of under 50 employees that isn't already stretched out in today's economy when business is good, that are going to survive. I am estimating that, barring an emergency measure or a miracle, we are going to see over a half-million small businesses quit business within the next 6 months.

Senator CHAFEE. Good Lord, that is a depressing prediction. Within 6 months?

Mr. PEARSALL. Within 6 months. That is only 5 percent of those 10 to 13 million small businesses.

To verify that, I spoke to a group last week that were business representatives, each of whom had about 10 small business clients. Totally there must have been 300 small businesses represented, later confirmed the number nearer 1,000. I made that statement to them and asked them, in their opinion, from the percentage of people that they represented, would that statement hold water. They said it was underestimated.

That is a conjecture. Nobody's crystal ball is really good in this area. But I am deeply concerned that the interest rate problem and the Federal Reserve restriction on bank loans today is going to impact the small business community most severely and it will be compounded by a recession, and the customers of those small businesses are vulnerable to recession. We have a social crisis facing us.

Those are my two main concerns. In the interest of time, the two bills that impress me most are the rollover provision, which started with the Casey report in 1977, and which has not survived the congressional process as yet, but it is the one bill, to me, that will tend to infuse capital back into the small business community that has eroded over the past 25 years; and the second one is the small business——

Senator CHAFEE. You know, I don't quite understand why you and Mr. Little and some of the other witnesses have attached so much to that rollover provision. The rollover provision permits a person who has invested in a small business to get out of the small business and reinvest in another small business.

Now, explain the great significance of that as far as preserving the small business, you or Mr. Little, and one of our other witnesses spent a lot of time on that. But I guess we have got the expertise here. Go ahead.

Mr. PEARSALL. I will give you a quick example. I have been on the other side of the picture trying to get investments in our business to survive. Now I am on the opposite side of the picture and I am investing in small business as a cause.

My wife disagrees with me.

Senator CHAFEE. Wives frequently do.

Mr. PEARSALL. Yes, they do. She cannot understand why I would invest in a small business, because when you do, your investment is so illiquid, you are in that business for a long time, and you are a part owner whether you wanted to be or not, as opposed to the liquidity of a major blue chip company where you have a predictable return, predictable relative to small business.

So the illiquidity of small business has forced capital away from small business and into Government securities and blue chip investments. What we need to do is to stop this erosion of capital out of the small business sector and in some manner, in a broad fashion, suck it back into the small business sector.

Senator CHAFEE. I appreciate that, but how do you get liquidity out of the fact that you can rollover. Is somebody going to come along and buy your investment, buy you out? Let's say you are a minority stockholder and shareholder in a small business.

Now, we acknowledge there is no liquidity to it. How does this act help that?

Mr. PEARSALL. It is the deferral of the tax bite that is the big carrot to get investors into it. In my case, I cannot survive and meet inflation rates by investing with interest income. If I had some carrot that would give me a long-term deferral where I could pull it out with an equity gain at some future time with just capital gains burdens on it, that is a great incentive.

To quote a financial adviser in Denver the other day, a very sophisticated one, he said, "if the rollover proposition got into position, I would advise half of my clients to invest in smaller businesses that qualified under this act. I think it is a tremendous incentive.

Senator CHAFEE. Obviously each of you do think it is tremendous, because it has had such high priority on the various list that have come in here. You have got to assume that if you are there, you are in, that this rollover provision will encourage lots of other people to come in and thus help you get out.

Is that it? I mean there is somebody to buy your stock, your minority share, or you are locked in position.

Mr. PEARSALL. I think your scenario misses the point that the small business is short of capital to begin with. They have got more ideas than they have capital to exercise.

What I am considering is that this would be a means of enlarging the productivity of the small business sector by numbers and size of those businesses, instead of going at it with anti-merger legislation at the top end.

Senator CHAFEE. Mr. Little, do you have anything to add?

Mr. LITTLE. I think again you come back to the fact that—well, I haven't been in Mr. Pearsall's position, but let me put myself in his position for a moment. And this, of course, goes for us as investors, as well.

We have a situation where you make an investment in a business, and what are our ways out, either way? We can either sell that business for cash or we can sell that business by taking stock back from a large company. If we sell for cash, we get an immediate 30 percent bite out of that dollar that we receive. Now, that is immediately 30 percent that we cannot turn around and invest somewhere else.

Obviously, you are much more likely to sell out to a large corporation in a stock for stock deal. That is a tax deferral also. So what we are really saying here is give us something that is equally as good a tax deferral if we want to sell the business for cash.

With a smaller business, one of the things that you do by having the large corporation be in the position of trading you stock for stock is that if that is your only way to get a tax deferral, you then eliminate another smaller business who comes along and says, well, obviously you don't want to take my stock, because my stock is just as illiquid as your stock. So we have to have a cash transaction.

Well, if you take the cash transaction, then you are immediately going to have to pay some taxes on it. So what you want to have here is the ability to get some cash and then turn around and reinvest that cash in another small businesss.

Or every once in a while, we in our business meet these people who are not just involved in one small business but are involved in four or five small businesses. They take that cash out and invest it in one, two, three, four places. It just stretches the dollars that you invest 30 percent further, and it also puts you in a position where there is a great deal more choice as to where you might sell your business.

And you also take a great deal of the balance or the tipping the scales away from selling out to the larger business. Have I missed anything there?

Mr. PEARSALL. That is it exactly. I think there is a gross inequity today. I sold out on a stock exchange basis, and it was a good thing to do. It was very timely. But I didn't have an alternative. And I think what we are talking about in the rollover provision is that you have an opportunity here to have an alternative to the inequity that currently exists in selling out to big business.

Senator CHAFEE. I think that is true, although when you end up with the rollover, you are still in an illiquid position. You are still locked in, except if you get out, until you pay your tax.

Mr. LITTLE. Sure, but you are also making the presumption that you are going to reinvest all of the funds that you get from your buy-out into a new business. Let's say that you end up getting $1 million, just to take a nice, round figure. Well, you may not. One of the problems that I have with the rollover is I am not sure that the period to reinvest your funds is long enough, given the kinds of securities that you have to reinvest in.

So it may be that Mr. Pearsall gets $1 million. He can only find $500,000 to reinvest. He has still got to pay taxes on that $500,000. He has got some cash, he has got some liquidity there, but on that other $500,000 he reinvests, you are saving approximatey $150,000 that can go into, again, a small business.

I foresee, with some of the people that we have dealt with here, that this isn't going to be just one small business to another. It is not going to be two businesses; it is going to be 3 and 4 and 5 and 10 and quite a number. Now, not everybody is like that.

Senator CHAFEE. I understand that, and those are good points. I suppose you would like the longest period possible, 24 months as opposed to the 18.

Mr. PEARSALL. That is a point that concerns me. Eighteen months is really not enough to reinvest properly. It takes a long time.

Senator CHAFEE. What do you say, Mr. Little?

Mr. LITTLE. I would opt for 5 years, myself.

Senator CHAFEE. Five years?

Mr. LITTLE. Yes. What I would like to do, Senator, is the next time you are in the home district, let me come and sit down with you and I will go over this with you in detail.

Senator CHAFEE. Let me see. I guess it was Mr. Derieux that addressed this in some detail. Fine.

[The prepared statements of the preceding panel follow. Oral testimony continues on p. 778.]

NASBIC

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RECOMMENDED TAX CHANGES

Top Priority: Capital Gain Rollover for Small Business

Other Recommended Initiatives:

1. Adopt the Small Business participating debenture.
2. Reinstate qualified stock options.
3. Liberalize Subchapter S so as to make it more useful for venture capital investment.
4. Graduate the corporate income tax to $500,000.
5. Reduce the maximum personal income tax rate to 50%.
6. Adopt a simplified and more rapid depreciation system.
7. Revise estate tax laws to ease burdens in family-owned businesses.
8. Provide a tax credit for initial investments in small businesses.

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* EXECUTIVE COMMITTEE

STATEMENT OF

ARTHUR D. LITTLE AND

HARRY S. FLEMMING

Before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

U. S. SENATE

April 1, 1980

Good morning Mr. Chairman and Committee Members. I am Arthur D. Little, President of Narragansett Capital Corporation, the nation's largest publicly held small business investment company. This year I am also serving as President of the National Association of Small Business Investment Companies. With me today is Harry S. Flemming, President of Inverness Capital Corporation located in Alexandria, Virginia. Harry is also very active in our National Association and serves on our nine-member Executive Committee which carries the basic responsibility of setting and maintaining Association policy.

Mr. Flemming and I are deeply involved in entrepreneurial activities and venture capital investments, and we are pleased to testify today on matters about which we have very strong feelings. I will present some basic background information on SBICs and small business investment. I will also outline the various tax proposals which our Association supports. Mr. Flemming will then describe in greater detail the proposed tax change which we feel would be most helpful for smaller business and the Nation.

The central message we wish to bring you is that the country must support capital formation for small business in every way possible. It is small business which is the innovator, the competitor, the job-creator. Independent growth firms are the new blood in our economy which reinvigorates the entire free enterprise system.

SBICs are privately formed, privately capitalized and privately managed venture capital investment firms. In return for agreeing to invest only in small businesses and to abide by the regulations of the Small Business Administration, SBICs are permitted to borrow funds from the Federal Financing Bank up to a maximum leverage rate of 4-to-1 with a ceiling of $35-million to any SBIC. All private capital is at risk, and, since it is subordinated to the government leverage, the private investor loses 100% before the government loses a nickel. There is no pro rata sharing as in certain types of government sponsored programs. Over the history of the SBIC program, the direct loss to the government has been miniscule when compared to the dollars of funding provided and the revenue gains to the Treasury because the growth of the small businesses we have financed has been great.

Our Association has always known that the real benefit of SBIC investments comes from the growth and vigor we help produce in the companies in which we invest. Until this past year, however, a comprehensive study of that growth had never been conducted.

Various studies over the years have shown how small companies can grow faster and generate greater economic activity than mature corporations. One such study conducted by the Massachusetts Institute of Technology Development Foundation compared the performance of six mature companies, five innovative companies and five young, high technology companies. From 1969 to 1974, the average annual contribution of those companies in terms of jobs and revenues was as follows:

Type of Company	Sales Growth	Job Growth
Mature	11.4%	0.6%
Innovative	13.2%	4.3%
Young high-technology	42.5%	40.7%

Another project, very broad in scope and sponsored by MIT, concluded that small firms (20 employees or less) created 66% of all net new jobs in the U.S. between 1969 and 1976.

A survey conducted by the SBA sampled SBIC-financed small businesses and found that those companies achieved annual growth rates of 25% for employment, 27% for revenues, 27% for profits and 35% for assets.

A more recent study which was conducted by the American Electronics Association showed that among AEA members, which included young, intermediate and mature corporations, the employment growth rate for companies between five and ten years old was 55 times the rate in mature companies. It also found that for every $100 of equity capital invested in young companies founded between 1971 and 1975, those companies generated, spent or paid in 1976 alone:

- $70 in exports,
- $33 on research and development,
- $15 in federal corporate income taxes
- $15 in personal income tax revenues, and
- $ 5 in state and local taxes.

All these studies are impressive, but none comprehensively analyzes what is happening within the SBIC portfolios. Recognizing the need for a comprehensive analysis, our Association last year authorized such a study. The accounting firm of Deloitte, Haskins and Sells generously volunteered to compile and key punch data and to provide computer programming services. We then engaged an economic consulting firm to oversee the study and interpret the results. Although the final results of our study will not be prepared in a form for official release until mid-April, I can tell you some of the findings at this time. For purposes of illustration I am including in my testimony the growth table on the following page showing SBIC-financed companies far outstripping small business in most performance categories.

The Economics of Small Business Financing

All businesses rely on both internally and externally generated capital for growth and development. Small companies, however, are finding it more difficult both to retain the capital they generate

A COMPARISON OF THE GROWTH OF SBIC PORTFOLIO COMPANIES WITH THE GROWTH OF ALL SMALL COMPANIES*

Year of Initial Financing:	PRE-1972		1972-1975		1976-1977	
	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES**	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES**	SBIC PORTFOLIO COMPANIES	ALL SMALL COMPANIES**
Employment	384%	29%	155%	19%	48%	8%
Sales	896	76	386	27	81	16
Profits	1,165	144	553	25	52	53
Assets	694	48	188	24	92	13
Federal Corporate Taxes	739	135	652	63	85	57

*For SBIC's, growth rates are measured from the year prior to SBIC financing to the most recent fiscal year. For small companies in general, the comparison is from 1970, 1973 and 1976, to 1978.

**For financial measures, manufacturing corporations with less than $5 million in assets. For employment, all corporations with less than 100 employees. Percentages for employment and taxes for all small companies for 1978 were estimated based on historical data.

Source: Federal Trade Commission, Quarterly Report of Manufacturing Corporations, U.S. Bureau of the Census, County Business Patterns and Arthur D. Little, Inc., estimates.

and to attract outside capital. Because of the impact of federal taxes, increased government regulations and inflation, small companies are forced to increasingly look to outside sources for financing. The American Electronics Association Task Force on Capital Formation study cited earlier indicated that among 276 electronics firms founded since 1955, the amount of expansion capital provided by retained earnings was less than 30%. That means that these companies had to finance almost 3/4 of their growth from outside sources. It is important to look at what young companies do when faced with finding nearly 3/4 of their capital from outside sources.

Some companies cannot find financing, and continue to operate in an undercapitalized state. Others merge with large corporations. From 1972-1977 the Federal Trade Commission reported that over 75% of all mergers were between very small companies (with assets of less than $1 million) and large companies, (42% of which had assets in excess of $100 million).[1] Once absorbed into the body of a larger company, these small firms are apt to lose their independence and flexibility, and also may innovate less rapidly than their independent counterparts. Another even less desirable result of the shortage of equity capital is the threat of foreign acquisition of small U.S. high-technology firms. A June 14, 1979 report of the Senate Small Business Committee listed a number of high-tech companies

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[1]Source: Federal Trade Commission, Statistical Report on Mergers and Acquisitions (1973-1978).

n fields such as data processing, advanced electronics, and vehicle nd telecommunications electronics in which a controlling or near-controlling interest had been acquired by foreign investors. This s indeed a very serious problem.

If a young company is lucky, it will survive as an independent entity and avail itself of outside venture capital -- i.e. long term growth dollars provided by SBICs or non-SBIC venture capital companies during the highest risk stages of a young company's growth cycle. Currently, however, venture capital is going into small business at an annual rate of only about $1 billion. Certainly more is needed to finance young companies today which will be major corporate competitors of tomorrow. More is needed to keep our economy, with its current gross national product in excess of $2.5 trillion, healthy and growing for many years to come.

SBIC-venture capitalists generally take a minority ownership position in the companies they assist and hope to achieve capital gains. The 1978 reduction of the individual capital gains tax from 49% to 28% has had a most beneficial influence on the amount of money flowing into venture markets. Demand has increased along with supply. Entrepreneurs, perceiving the greater potential for reward, are requesting capital in larger numbers than ever before. Many of them are seizing upon the opportunity to leave other employment to establish their own companies. To meet this heightened demand, there has been a steady increase in the amount of funds committed to private investors since 1978, when strong Congressional support of the tax reduction became apparent. In the past two years, for example, venture capital companies have received commitments of new capital for investment into private partnerships in excess of $385 million, compared to $20 million in 1977. In addition, 82 new SBICs have been formed with private capital of $104 million, which can be leveraged at least three times.

These signs are encouraging, but it must be remembered that in spite of the increase in available venture capital, it takes much greater investment to develop a new business today than it did ten years ago. Not only have labor and equipment prices risen dramatically, but our high rate of inflation erodes real gains from even the most successful investments. The venture capital drought of the past decade has created enormous pent-up demands for risk funding, and our Association strongly feels that it will take more changes in tax policy to bring forth enough venture capital to fill that demand.

Tax Initiatives

Our Association supports all of the five major capital formation initiatives proposed by the recently held White House Conference on Small Business.[2] Two of the White House proposals in the capital formation area are at the top of our Association's list in the tax area. Specifically they are: 1) more effective capital cost recovery and 2) the capital gains "rollover". Our Association strongly supports the Nelson-Bentsen-Packwood capital cost recovery proposal, S. 1435. Our top tax priority, however, is the rollover. After touching on a few other tax initiatives our Association feels would be very helpful, I will turn the "mike" over to Harry Flemming who will talk in more detail about the type of rollover we feel would be most helpful to small companies.

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[2]The five major capital formation proposals of the White House Conference on Small Business are as follows:

A. Replace the present corporate and individual income tax schedules with more graduated rate scales, specifying the graduated corporate tax scale up to $500,000, and reducing the maximum personal income tax rate to fifty percent from seventy percent.

B. Adopt a simplified accelerated capital cost recovery system to replace the present complex Asset Depreciation Range (ADR) regulations, with provisions such as (a) immediately expensing capital costs less than a specified amount, (b) immediately expensing government mandated capital costs, and (c) the creation of a maximum annual benefit that may be derived from the system.

C. Revise estate tax laws to ease the tax burden on family-owned businesses and encourage the continuity of family ownership.

D. Provide for a tax credit for initial investment in a small business, and permit deferral of taxes for rollovers of investments affecting small businesses.

E. Provide tax incentives in the form of a new security called a Small Business Participating Debenture (SBPD) to provide a source of capital for small businesses.

In addition to the White House Conference proposals, our Association believes that qualified stock options should be reinstated. I would suggest that, in order to give managers a real incentive to join smaller firms, options of the pre-1969 variety must be made available. Small businesses are seldom able to match the salaries and fringes paid by large corporations, so its hard for them to grow by attracting the highly competent managers they require. The qualified stock option is a means of permitting new and growing concerns to employ qualified people and to allow those employees to share in the growth of the businesses for which they work. I believe the action of Congress in removing the tax advantages of stock options is another example of legislation which had an unintended adverse impact on small business. It's surely time to reverse that wrongful decision.

Our second supplemental tax recommendation concerns Subchapter S corporations. For almost twenty years, SBICs have asked Presidents and Congresses to make a minor change in Subchapter S. While the Treasury Department has promised on numerous occasions to send a proposal to Capitol Hill, it has never done so. Specifically, we think that SBICs should be able to own stock in Subchapter S corporations. Under present law, SBICs are precluded from doing so. Also, a second change we recommend in the Subchapter S statute is the removal of the passive income test for SBICs so that such companies could qualify for and elect to be taxed as Subchapter S corporations. It is certainly the intent of Congress to foster the formation of capital in small companies through the SBIC program. Allowing SBICs to be Subchapter S corporations would further that Congressional intent. Finally, we recommend that partnerships also be permitted to own stock in Subchapter S corporations. Most non-SBIC venture capital firms are organized as limited partnerships and smaller firms should be able to attract funds from those companies without losing their Subchapter S option.

Rollover

The rollover concept has certainly come to mean different things to different people. Most, but not all, seem to think in terms of capital gains when the term "rollover" is mentioned. In the small business area, several concepts are known.

One rollover would allow a capital gain realized in a small business to be rolled over into anything. While that would be very desirable for owners and investors in small businesses, we feel that such a concept would not serve the capital formation needs of small business by allowing gains to be rolled out of small companies and into less risky larger investments e.g. government securities or "Fortune 500" equities.

Another type of rollover would allow a gain realized on any investment to be rolled over if reinvested within a small business. Such a provision would certainly attract a great amount of capital.

Another concept would establish investment accounts in which individuals could invest in anything, and all income accruing to that account, be it capital gain or dividends or interest, would be rolled over, i.e. the tax would be deferred until such income were withdrawn from the special account. While such a proposal is a worthy one, we do not feel that it alone would provide the flow of new venture and equity dollars into small companies that is currently needed.

Since most venture capital today is invested by institutions, a rollover account directed towards individuals will be of little help. Certainly some individuals will invest in small and private companies but the practice would not, in our estimation, be widespread. Indeed, the securities laws currently limit participations of individual investors in small private companies so that even if syndications of individuals were put together, they would be very limited. We therefore strongly recommend that any rollover provision which is introduced into law by the Congress be expanded to include institutional investors, particularly SBICs which must, by law, reinvest all proceeds in new and growing small businesses.

While venture capital benefited greatly from the capital gains tax reduction of 1978, much more is needed. Additionally, most of that venture capital has flowed into limited partnerships which are created for a specific purpose and usually have a limited life of approximately ten years. That partnership popularity flows from the fact that the 1978 capital gains tax change signaled a major reduction for individual capital gains thereby making the partnership vehicle relatively more attractive. The corporate venture capital vehicle is still much in need of tax incentives.

A fourth type of rollover covers the situation where the proceeds of sales of securities issued by businesses when they were small are reinvested in other small businesses. We feel that such a rollover is equitable, fairly balanced against other public policy goals, easy to administer and potentially very helpful for the small business community.

Our association strongly supports the rollover introduced by Senator Gaylord Nelson (S. 653). That is essentially the proposal endorsed by the White House Conference on Small Business and it would provide a deferral of tax if a gain realized in a small business were reinvested in another qualified business within a specified period of time. Essentially the rollover we envision would operate similar to the primary residence rollover in contrast to the IRA-type rollover, i.e. focusing primarily on the characterists of the investment property rather than on that of the investment instrument.

I wish to emphasize, however, that the two proposals are not mutually exclusive. If Congress should choose to do so, the small business rollover and the investment account rollover could easily be combined into one piece of legislation.

A Nelson-type of capital gains rollover would meet two very desirable objectives. First, an entrepreneur would be able to sell his business and go into another without a major tax impact. Currently, he can avoid the tax only if he sells out to another corporation in a stock transaction. Thus, for purposes of tax planning, entrepreneurs regularly do that. The result, of course, is an even greater bias towards concentration in the economy -- something for which the tax code is directly responsible.

S. 653 is a good piece of legislation in our opinion since it would channel more dollars into small companies, this bill if passed would have a significant impact on venture capital investment in small companies.

From the preliminary indications we have received, this bill would not be expensive. It would also in the long run increase competition by relieving some of the pressure which is currently on small businesses to merge into large companies relying upon Section 368 of the Tax Code which allows such mergers to be conducted tax free.

Additionally, S. 653 would allow for a capital gain to be rolled over from a small business into another small business or a small business investment company. That would take care of the problem of the older entrepreneur who might not want to start another small business. He could then invest in a small business investment company where his funds could be professionally employed in the venture capital industry. We feel, however, that the rollover should be granted for limited partnership interests so as to allow investments in limited partnership SBICs and small businesses.

While firmly supporting S. 653 in concept, we would wish in closing to make just a couple minor suggestions which will make the bill much more effective in accomplishing its purposes. First, S. 653 provides that in order for a gain to be deferred it must be rolled over within an 18 month period. We feel that such reinvestment period is inadequate because many times it's difficult to find a new investment in a short time. Our Association strongly recommends that the reinvestment period be at least 24 months. Experience in our industry proves that it may take as much as five years to reinvest the proceeds from the sale of a highly-successful "winner". Secondly, the small business participating debenture is a concept which is gaining wide support. It was one of the recommendations of the White House Conference on Small Business and as mentioned before our Association supports the concept. We would recommend that Congress in adopting the small business participating debenture, also allow that capital gain to be rolled over into common or preferred stock or also small business participating debentures. This would allow outside investors much more flexibility in structuring their investments and would in many instances be much preferable from the standpoint of the small business owner.

Our final comment on S. 653 is really a technical drafting comment. S. 653 allows a capital gain to be rolled over into a small business or an SBIC but it applies the passive income test as defined in Sec. 1372(e)(5)(C) of the Internal Revenue Code. Since that section mandates that no more than 20% of income can be from royalties, rents, dividends, interests, annuities, and the sale or exchange of stock or securities, no SBICs would be able to qualify. In fact, the bill would create a real "catch 22". If an SBIC received more than 20% of its income from the above categories, it would not qualify for rollover under S. 653. If the SBIC, on the other hand, rearranged its activities so that it qualified under the passive income test, it would no longer qualify as an SBIC. A proper redraft should include SBICs as qualified replacement property, but not subject them to the passive income test under Section 1372 of the Code.

Summary

In summary, our Association strongly supports the five capital formation proposals of the White House Conference on Small Business. We more specifically support the Nelson-Bentsen-Packwood Capital Cost Recovery Bill and the Nelson Rollover Bill. In addition, we support qualified stock option legislation and liberalization of Subchapter S. Our top priority is the rollover bill and we feel that Congress, in order to provide equity for enterpreneurs diversifying out of their businesses and to provide incentives for corporate venture capitalists to finance more small businesses, would be both wise and prudent to enact the Nelson small business rollover provision.

NFIB National Federation of Independent Business

STATEMENT OF

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NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Finance Subcommittee on Taxation and Debt Management

Subject: Proposals for the Encouragement of Small Businesses through Tax Reforms and Capital Formation

Date: April 1, 1980

Mr. Chairman, on behalf of NFIB's 600,000 small and independent business members, I appreciate this opportunity to express our views on the capital retention needs of small business.

Capital retention is a particularly important part of small business' capital formation process. While investor financing is available and desired by some small firms, it is and will always by atypical. Capital retention (earnings or profits) and bank loans are the two normal methods of financing a small business. Since bank loans are generally contingent directly or indirectly on the earnings of a small firm (no small versions of Chrysler need apply), the ability of a small business to retain capital is particularly vital to its operation.

Small business is all too often overlooked and misunderstood as a macro-economic factor. Aside from the jobs it creates and the innovations it produces, there is evidence of higher capital productivity than has large firms.1/ That is to say, for every additional dollar invested in a small business, the increase in wealth generated is proportionally larger. Such indirect investment as a small business thereby produces societal gains. NFIB does not mean to argue that the corporate giants don't have their problems, but the small firms have a vital economic role beyond that of simply supplying competition.

All too frequently it has been assumed that the contribution of small business to economic growth is fundamentally passive. The large macro-models tend to support that view, as well they should. Lacking the fundamental ability to simulate the operations of the entrepreneur as a unique economic entdity subjected to differing economic stimuli and reacting in differing manners to similar stimuli, the result of such models are predictable. (For example, how possibly can employment be understood without new entries being considered?) Dependence on them by policy makers, therefore, tends to distort the policy alternatives assessed and the results achieved. One delegate to the White House Conference summarized small business' view of Treasury's criticisms of several tax reducing measures in saying "What do they think we do with the extra money? Bury it in the yard?"

From the small business perspective, there is a second major point of tax policy. Tax provisions which are esoteric and complex but provide an "ideal" distribution over the business population are not equitable. A tax incentive is valuable only if it can be used. If, as a practical matter, a tax incentive cannot be used by a substantial portion of the population, than an unfair anti-competitive bias has been instituted by law or regulation. This is the principal reason NFIB feels small business will do reasonably well under the 10-5-3 depreciations proposal.

The following contains NFIB's "shopping list" of capital retention priorities. They are not the same as the White House Conference's simply because NFIB represents all small business where the Conference delegates were disproportionately large, corporate, and capital intensive. It is, therefore, important that you review Table 1 carefully understand the effect various capital retention proposals will have on which small firms.

Payroll Taxes

Of the various forms of direct taxes paid by small business, payroll taxes (social security and unemployment compensation) are the costliest to a majority of firms (see Table 1).

Small businesses paid a conservatively estimated $28 billion in total payroll taxes in 1979. This figure amounted to roughly 41% of the total paid in by private sector employers.2/ An estimated $22.5 billion alone was paid by the small business sector in social security taxes.3/ Given that total FICA taxes paid in by private employers was roughly $53 billion in 1979, small business accounted for an absolute minimum of 37% of the total private sector employee payroll tax contributions.

Despite the existing level (and adverse consequences) of payroll taxes, higher and higher levels are anticipated. The Social Security Financing Act of 1977 raised tax rates from 5.85% to 7.15% and the wage base from $16,600 to $42,600 over a ten year period. Even that will not be adequate to cover legislated benefits. We already have a "temporary" cash flow problem in the OASI fund which some feel may not be covered by "borrowing" from other funds.4/ We face a conservatively estimated $632 billion (1977 dollars) long term shortfall in OASI alone 5/ and tax rates possibly doubling those today.4/ And that is only Social Security. States like Pennsylvania are discussing increased unemployment compensation taxes to repay the Federal government for loans received during the last recession. Another recession surely will add to pressures in several states to maintain, if not add, payroll taxes to cover unemployment compensation costs. Finally, the Congress is discussing a national health insurance program. While the proposals are many and varied, at least some consideration has been given to financing national health insurance through direct payroll taxes. As a result, <u>the payroll tax problem small business faces not only is one of coping with existing levels, but of averting extraordinary increases</u>.

Payroll Tax Effects on Business Starts

It is clear small business has been the sector primarily responsible for the incredible increase in the number of net new jobs over the past decade. David Birch at MIT has estimated that between 1969 and 1976, 2/3 of the nation's net new private sector employment came in firms employing 20 or fewer persons. Eighty percent came in firms employing 100 or less.7/ While these data have been generally recognized and often publicized, Birch's second major finding is overlooked. He notes that employment loss due to business failure is virtually constant throughout the country. Migration is of virtually no consequence. The net gains in employment result from the number of new business starts and the expansion they undergo in their first four years of operation (Tables 3 and 4).8/ Thus, it is the new expanding business (almost always quite small) which has had such an important and positive effect on employment.

The majority of the nation's technological innovations also came from small business.9/ These are often new, rapidly growing firms. Without them, our dismal productivity record over the past decade would be even worse. But the evidence is that the number of new innovative firms has been decreasing, largely due to a lack of capital.

It is an understatement to note the vulnerability of new small businesses. Typically, the new entrepreneur is inexperienced, woefully underfinanced, and can expect an initial period of unprofitability. For example, nine of ten have not owned and operated a business previously.10/ While a majority of new entrepreneurs have had some type of management or marketing experience working for others prior to entry, running the entire operation from finance to personnel is considerably different. Further, 60% of the people starting their own business (in contrast to purchasing an on-going business, inheriting or purchasing a business from a relative, or buying in) have as their <u>major</u> source of financing -- personal resources (see Table 5).11/ Virtually every type of new business venture is heavily dependent on the personal resources of the owner(s). This generally means a pinch on cash flow, negligible capital for business investment, and absolutely no non-essential personal expenditures. Not surprisingly, the turnover rate is high.

The impact of payroll taxes on such firms is particularly onerous. It raises the fixed costs of doing business exactly when the business is most vulnerable and most in need of capital. With taxes levied on employees, the entrepreneur's tax is not related to income, financial health of the business or anything of that nature.

Obviously, existing payroll taxes are regressive for both employers and employees. But in a very real sense, payroll taxes are more regressive for new entrepreneurs than for any other group. The payroll tax levy on employees at least bears some relationship to earnings. That is not true with the new entrepreneurs. In fact, quite the opposite appears to be occurring. While regrettably no data exists to support or refute our observations, it appears that because a new venture tends to be undercapitalized, the labor-capital mix is heavily tilted toward labor and will continue to be until such time as the business is sufficiently profitable to begin substituting capital. Thus, the taxes paid on labor bear most heavily on the new entrepreneur.

Second, because the new venture is so frequently undercapitalized, the wages paid to employees tend to be lower than in comparable firms of greater longevity. That means a larger percentage of payroll will be subject to taxation. Remember, both FICA and UC have "wage bases". Once those bases are exceeded, no tax is levied. Thus, as a general rule, the greater the range in wages paid and the higher the wages paid, the lower the tax as a percent of payroll.

Third, unemployment compensation tax rates can actually be higher for new firms than most established firms. Each State determines its unemployment compensation tax rate based on the experience of the firm in having former employees collect from the fund. These "experience ratings" have a ceiling and a floor.

Depending upon the individual state, firms must accumulate unemployment experience from one to three years before receiving a tax rate based on their actual unemployment experience. New firms in 39 states must pay an effective tax rate of 3.4 percent until they are assigned an experience rating. Moreover, this tax rate does not vary across industries, and therefore does not take into account the employment stability a new firm is likely to achieve in a particular industry, based on the industry's historical employment stability record. Consequently, two scenarios are likely to develop. First, new firms may benefit relative to their experienced rated competitors if they are in an industry which is usually assigned maximum rates under experience rating. Second, new firms will be at a disadvantage relative to their experience-rated competition if the industry has a very stable employment history. (1)

Finally, payroll taxes impede the development of new businesses by diverting needed resources to allow the firm to survive and grow. The two principle areas involved are cash flow and reinvestment, both of which affect a firm's ability to borrow and become a healthy business. Since both are important to a business and frequently misunderstood, each is explained with an example below:

> It has been common practice for a small business to receive a 2% discount on goods paid for within 10 days. If the goods are paid for in more than 30 days, a 2% penalty is added. If the firm has a healthy cash flow, it can take advantage of the discount and vice-versa. Thus, on the purchase of $200,000 worth of goods in a year's time, the difference between a good and bad cash flow is 4% or $8,000. That margin is sufficient to determine whether a new firm lives or dies.
>
> With energy costs rising and energy costs per dollar of sales inversely related, an energy conservation investment(s) may reduce overhead. Reducing overhead improves both the short-term and long-term profitability of the business. The more profitable it becomes, the more it can reinvest to become more profitable, and the greater its prospects for survival.

<u>The Impact of Payroll Taxes on Established Small Businesses</u>

The impact of payroll taxes on established small businesses is generally similar to that found on new small businesses, only less severe. Many of the financial handicaps experienced by starting enterpreneurs are either no longer present or are considerably reduced, including the ability to borrow. Yet, it would be erroneous to assume that payroll taxes do not have a significant adverse impact on established small businesses.

The first point to recognize is that as a group, small business spends a greater portion of its gross sales on payroll than larger firms (see Table 6). That, combined with the fact that small businesses have a greater portion of their payroll covered by "wage bases" means small businesses are paying a disproportionate amount in terms of percent of gross sales. Due to difficulties in handling the data for proprietorships, the comparison can't be made on the basis of percentage of profits.

Second, analysis of the actual unemployment experience ratings of business, by size of payroll, (as measured by the amount of benefits charged per dollar of contributions to the system), indicates that the smallest firms have in fact lower benefits to contribution ratios than larger firms. According to research conducted by Professors James T. Bennett and Manuel Johnson of the George Mason University, small experience-rated firms in the states of California, Wisconsin, New Mexico, Oregon and North Carolina all had lower unemployment insurance tax rates (see Tables 7-11) 12/ There is no reason to believe that these states are atypical.

Third, while it is popular to view small entrepreneurs as "well-heeled" and hence capable of absorbing payroll taxes with only a modest reduction in one's standard of living and no business impact, that clearly is not the case.

NFIB survey data corroborated by Census figures, indicate a very wide range in the dollar amounts taken out of a business. For the year 1976, we estimated 7% were taking $50,000 or more from their businesses (salary, profits and return on investment) while 19% earned less than $10,000.13/ Considering the hours worked, the latter group was earning less than $2.85 per hour (a figure approximating the then minimum wage). Not surprisingly, the larger the small business, the greater the return.

Two other pieces of data indicate the lack of capital for cash flow and investment purposes small businesses now face. Over the last two years record numbers of small firms are borrowing. Approximately one of every two are now regular borrowers (defined as generally borrowing once every quarter) which is up from one in three only a few years ago.14/ One would, therefore, expect massive capital investment. Yet, between April and October, 1979, we saw 40% of small businesses making no capital investment, 8% with capital investment of less than $1,000 and another 20% with a capital investment of $1,000-$5,000.15/

These factors all have enormous implications on productivity and inflation, points which NFIB was not asked to address at this junction.

In conclusion, I would simply repeat that payroll taxes currently have an adverse and disproportionate impact on small, and particularly on new small, businesses. That is bad enough. But when we look at the potential of additional payroll taxes being imposed, it becomes absolutely terrifying.

Some Suggestions

Obviously, refusing to enact a national health insurance program or at least a program funded by payroll taxes, would be helpful. Second, Senator Boren has been conducting hearings on means to tighten the unemployment compensation program. The Senator is to be commended and we hope his subcommittee will review the question of experience ratings at some future time.

The largest payroll tax, FICA, is considerably more difficult. We will, however, recommend separation of the annuity and transfer functions of OASI program. NFIB shortly expects to have a precise proposal for consideration.

Depreciation Reform

Proposed legislation known as "10-5-3" provides an opportunity to greatly simplify depreciation tax rules and provide a great boost to capital formation. Inflation's effect on the cost of new capital equipment, as well as the undervaluation of depreciation tax deductions combines to severely limit new purchases of capital equipment and production capacities.

Historically small business has not been able to amortize the purchase price of capital assets as rapidly as larger businesses. While there may not have been a conscious attempt to cause this situation, the effect has been the same. The prime culprits have been the complexities of the Internal Revenue Code, the rules and regulations of the Internal Revenue Service and their attendent paperwork requirements.

The only relief afforded business in the capital recovery area recently is a very complex alternative called Asset Depreciation Range (ADR). However, small business is generally precluded from using the ADR method as a practical matter, since the second paragraph of the regulations refer to 25 definitions necessary to understand terms used in ADR! (Reg. 1.167 (2)(2)). Since 95% of depreciable assets of ADR electors are those with companies with assets in excess of $100 million, this amounts to a benefit almost solely available to giants (see Table 12). The amount of this benefit alone was estimated at $9 billion in 1974. The Capital Cost Recovery Act repeals ADR and more. For small business, the two most important aspects of the bill relate to the distributive benefits and to the simplicity.

The present system of depreciation is extremely complex. I refer you to IRS Publication No. 334, "Tax Guide for Small Business-1979 Edition." Starting with page no.44, the amount of description used here could be reduced significanly by eliminating major portions of the verbiage due to the simplification of the Capital Cost Recovery Act. The section entitled "Useful Life" could be eliminated; the section entitled "Salvage Value' could be eliminated; the subject entitled "Additional First Year Depreciation" can be eliminated; the "Methods of Computing Depreciation" can be eliminated, since there will only be one method. In lieu of this, there could be a reasonably short section saying: "Method of Computing Depreciation", which might read as follows:

There are three types of assets generally used in computing depreciation:

1. Automobiles and Light Delivery Trucks -- the first $100,000 is deductible over three years as outlined in the attached schedule.

2. All other tangible personal property is depreciated over 5 years using the attached schedule.

   The investment tax credit is 6% for the first $100,000 of automobiles and light delivery trucks and the balance of tangible personal property receives a 10% investment tax credit.

3. Real property that is non-residential which has a useful life now of 10 years, is depreciated over the attached schudule.

This eliminates the explanation for straight line method, declining balance method, salvage value and sum-of-the-years digits. Under the section that is called "Real Estate Depreciation", they give a brief description of the methods for calculating depreciation on real property which primarily are for non-residential real property. The 10 year life method and the old rules apply for other types of real property.

The brief explanation of class life asset depreciation range system which is used by over 90% of the major corporations can be eliminated

It should be pointed out that the explanation under "Class Life Asset Depreciation Range System" is so vague and general as to preclude the utilization by the normal small business. It is obvious why the description is not broader in the brochure, since the first regulations under ADR requires a knowledge of some 25 different terms which may explain why the advantages of ADR have been enjoyed by major corporations and not by the average small business.

There are a number of other simplifications that are helpful to small business that aren't emphasized in this previous comparision. Once fully implemented, the system will allow the average small businessman to go to the "Tax Guide for Small Business" and figure this own depreciation assuming that IRS is clever enough to add a worksheet for these purposes!

All choices have basically been reduced down to a very few. The system automatically qualifies the small business for the benefit of accelerated depreciation. If the small business decides that there is too much depreciation in this year, they may carry it over to a future year which serves as a mehtod of income averaging for the companies with less than $100,000 of taxable income.

The major complexity of the Bill is in the transition rules. To facilitate this complexity for small business, we recommend that in the Class 2 Category, $100,000 of additions be allowed or allowable for the new lifes at once. This removes any problem of transition from over 90% of the corporations.

If 10-5-3 is adopted, small business will gain substantially more due to the accelerated rates used in 10-5-3 than will larger firms, whose abilities to use ADR bring their depreciation expenses closer to what 10-5-3 would allow. Additionally, a frequent area of IRS review will be eliminated, simplifying the reporting compliance programs.

<u>Inventory Reform - Cash Method of Accounting and Simplified LIFO</u>

The method which a firm will use to identify its inventory directly affects tax liability. Of the available methods only the "Last in First Out" (LIFO) method provides assistance during a period of rising prices. The method, however, requires a complex set of calculations and determinations to be used.

The LIFO method in practice allows a tax deferral for the effect of inflation on a firm's inventories. Inventory valuation directly affects a firms tax liability. During our recent history of inflated prices the overvaluation of inventories has caused a tremendous drain on retained capital by overtaxation. However, use of the LIFO method requires an experienced tax professional and many hours of work to determine the LIFO method to be used and how it is to be implemented.

For retailers and wholesalers to be able to comply with IRS (LIFO) regulations, it is necessary for them to understand various new concepts -- base year, pooling, dollar value pools, dollar value method, specific goods method. These concepts and many more must be understood for the business to identify its inventory using the LIFO method. Retailers and wholesalers need to separate their products by major lines, types or classes of goods. For each line, (e.g. meat, dairy, vegetables) a separate pool and identification procedure must be used, having the effect that General Motors may use fewer groups than a corner grocery.

I have only touched briefly on the many complexities involved in adopting the LIFO method. The best evidence of LIFO's complexities, however, is its use. According to the <u>Statistics of Income of Corporations</u>, 1974, the total number of corporations using the LIFO method of inventory valuation was 18,574 out of almost 2,000,000 active corporations, less than 1%. However, inflation continues to rise unchecked and small retailers, wholesalers and manufacturers continue to overpay taxes and deplete available working capital that could be used for growth. This provides for an anti-competitive market as small firms find themselves being taxed more heavily on a percentage basis than large firms.

What is needed is a new approach to inventory accounting for small business. One approach that has been suggested is a simplified method of using LIFO. This could be done by having Treasury and the Bureau of Labor Statistics develop annual inflation indices in various categories of retail and wholesale trades. These indices could be applied to the year's ending inventory to determine the deferral amount, effectively putting ending inventory on a LIFO basis.

Reform along this line would be helpful to some intermediate size businesses, but will not have any practical effect on huge numbers of small businesses. Many complexities would still remain, even if the number of pools are reduced and published indices are available. The concepts of a LIFO system, LIFO definitions and the LIFO pool deferrals would be too complex to be comprehended easily for small business. Further, the concept of LIFO pools representing a tax deferral would cause added difficulties because small businesses probably would not properly plan for the deferral. It is doubtful they would maintain the necessary funds to pay the tax liability in case of a pool liquidation.

The answer, we believe, is to allow a method of accounting currently available to small farmers, the Cash Method of Accounting.16/ This method would in effect allow a small business to expense inventories when paid. By allowing a small business to match current costs and revenues in this way, small business will be able to compete with big business on a more equitable basis. They will be able to retain more capital, which will provide the impetus for expansion and growth.17/

Let me quote from the committee report prepared for the Committee on Ways and Means by the staff of the Joint Committee on Internal Revenue Taxation, from section 447 of the Internal Revenue Code. "The Primary justification for the cash method exception for farmers was the relative simplicity of the cash method of accounting, which, for example, eliminates the need to identify specific costs incurred." The cash method treats income received as taxable income and expenses paid as deductions. This allows the immediate deduction of purchases of inventory, reducing net income and tax liability in the current period. This deferral will allow more internally generated capital to be created, which helps solve a major small business problem.

• The deferral of tax liability will be for no longer than the next accounting period, or usually the following year. The argument that many small businesses will attempt to shelter income, to limit tax liability or distort income, is absurd. Most small businesses are simply not capable of financing sufficiently large purchases of inventory.

Our proposal would be to allow a business which has inventory to use a cash option method of accounting until it has achieved a certain level of sales, say $2,000,000, at which point it would have to adopt a LIFO or FIFO method. This would allow a small business the greatest possible opportunity to use internally generated capital with which to grow particularly in the early critical years. Further, it would promote equity by permitting small business to be taxed on the same basis as big business.

Tax Rate Reduction

Corporate tax rate reductions as well as individual tax rate reductions were endorsed by the White House Conference delegates. They recognized that the unincorporated business as well as the corporation requires relief in the form of lower taxes. The present method structure of corporate tax rates inhibits the growth of small business. The mere fact that corporate rates for all corporations over $100,000 in taxable income are the same is highly inequitable. Further graduation of the corporate income tax is essential in today's inflated economy, so that smaller corporations can accumulate capital and expand. Further graduation will also help to equalize the competitive advantages currently enjoyed by big business.

Investment Tax Credit

Most small businesses that require investments of machinery and equipment when they are new will, out of necessity, buy used equipment. In fact, if the necessary depreciation reform does take place, there will be available a substantial amount of used equipment for manufacturers. However, the investment tax credit rules limit a firm to obtaining a credit on only the first $100,000 in used equipment. This discriminates directly against the new and expanding small business with large capital equipment needs.

We feel that there is no need for a limitation on the investment credit for used property and that this should be changed as a means towards increasing productivity.

Rollovers

NFIB is concerned that the continuity of a small business not be unduly disturbed by an owner's retirement or by large firms seeking to further concentrate their markets. NFIB members have approved two types of rollover concepts. One would allow a deferral of the first $25,000 of profits reinvested in a small business and the second would allow deferral of any capital gains as long as the reinvestment took place within 18 months.

Legislation which would include these two concepts would alter the trend towards further concentration of small businesses. It would maintain the relationship between a community and business owners of a community who currently work together. At the same time it would allow that the same benefits be available to a small business exchange as one selling out to a large business.

Conclusion

One addtional point needs to be made. The delegates to the conference represented, for the most part, the successful larger small business. The delegates recognized, and it was widely discussed, that smaller small business would not benefit to the same extent on many of their recommendations. The three areas which will directly help the new and growing business are:

1. Tax rate cuts for unincorporated as well as corporations,
2. Allowing a cash method of accounting for firms under $2 billion in gross receipts,
3. Payroll tax reductions.

These three proposals will directly assist the smallest part of the business population, no matter what its organization form is.

ENDNOTES

1. Edmunds, Stahrl, W. "The Capital Productivity of Proprietary vs. Corporate Business, University of California, Riverside, California.

2. Total unemployment compensation contributions were $15 billion in 1979 and small businesses were assumed to have paid $6 billion, or 40% of the total.

3. This figure is based on 1977 small business employee wage distribution and therefore underestimates today's actual figure. $22 billion should be regarded as the absolute minimum.

4. See testimony of William C. Hsiao, Associate Professor of Economics, Harvard University, before the Senate Budget Committee, February, 27, 1980.

5. See Michael J. Boskin, Professor of Economics, Stanford University and Director, Social Insurance Research Program, National Bureau of Economic Research, forthcoming paper.

6 A. Robertson," Financial State of Social Security Amendments of 1977", Social Security Bulletin, March 1978.

7. David Birch, " The Job Generation Process," MIT Program on Neighborhood and Regional Change, Cambridge, Mass., 1979.

8. David Birch, " The Processes Causing Economic Change in Cities," Prepared for Department of Commerce Roundtable on Business Retention and Expansion, February 22, 1978.

9. Office of Federal Procurement Policy/Office of Management and Budget, "Small Firms and Federal Research and Development," Report by Interagency Panel, 1977.

10. NFIB unpublished survey, "How Small Businesses Begin," November 1979.

11. NFIB survey, "How Small Businesses Begin", Novermber 1979.

12. James T. Bennett and Manuel H. Johnson, "Unemployment Insurance and Small Business: Economic Impacts and Policy Implications," unpublished paper, The George Mason University.

13. NFIB Employment Report For Small Business, 1977.

14. NFIB Quarterly Economic Report, January 1980.

15. NFIB Quarterly Economic Report, January 1980.

16. Internal Revenue Code, Section 447.

17. Report to the Comptroller of the Currency, December 19, 1979, Financing of Small Business, Derek Hansen and Associates, Inc.

TABLE 1

DIRECT IMPACT of VARIOUS TAX CHANGES on SMALL BUSINESS

(3.5 million small, non-farm employers)

Form of Tax Change	Estimated Number of Small Businesses Affected	Frequency of Affect on Individual Firm	Type of Small Business Most Affected
Payroll Tax Reduction	3.5 million	annual	all
Simplified Depreciation	1.75 million with new depreciable equipment or vehicles every six months	annual	wholesalers and manufacturers
Cash Accounting - $2 Million Gross Sales Cap	1 million	annual	smallest retailers, wholesalers and manufacturers
Corporate Rate Reduction	1 million	annual	corporations with taxable income -- tend to be larger small businesses
No Investment Credit Cap on Used Equipment	100,000 annual maximum - probably fewer	one-time	larger small manufacturers and some new entries
Roll-over	20,000 annual maximum - probably fewer	irregular and infrequent	?

TABLE 2

COSTLIEST BUSINESS TAX FOR SMALL BUSINESS — 1977

	TYPE OF TAX				
Form of Business	Payroll[1]	Business Income[2,3]	Inventory, Property	Other	Undecided
Proprietorship	43%	37%	16%	2%	7%
Partnership	46	32	16	2	4
Corporation	61	27	7	1	4
Annual Gross Receipts (in thousands)					
less than $50	31%	42%	21%	2%	3%
$50 - $99	44	34	17	2	3
$100 - 199	50	31	14	2	4
$200 - 349	58	28	9	1	4
$350 - 499	61	26	9	1	3
$500 - $749	62	28	6	1	3
$750 - $999	60	26	8	2	5
$1,000 - $2,999	60	32	5	–	3
$3,000 and above	46	41	6	2	6
Sector					
Retail	50%	31%	14%	1%	4%
Wholesale	49	36	8	1	6
Manufacturing	32	57	8	2	2
Construction	66	27	4	1	2
Non-Professional Services	53	32	11	2	3
Finance	62	28	4	1	5
Transportation	65	22	26	2	6
Professional Services	44	40	12	1	3
Agriculture	32	34	33	1	1
Unclassified	35	41	11	8	5
TOTAL	52%	32%	12%	1%	4%

[1] Includes any payroll tax, e.g. Social Security and Unemployment Compensation

[2] Includes State and local income taxes where applicable

[3] personal income tax for proprietors and partners; corporate income tax for corporations

SOURCE: unpublished tabulations, National Federation of Independent Business, 1978.

Table 3

Average Components of Employment Change for Metropolitan and Rural Areas by Region, 1970-72

Metropolitan

	NET CHANGE	BIRTHS	DEATHS	EXPAND.	CONTRCT.	INMIG.	OUTMIG.
Northeast	-6.6%	4.5%	-12.1%	10.9%	- 9.9%	0.2%	-0.3%
North Central	-4.3%	4.5%	-10.2%	10.6%	- 9.3%	0.2%	-0.2%
South	-0.0%	7.8%	-11.6%	13.6%	- 9.9%	0.3%	-0.2%
West	-3.5%	6.7%	-13.9%	14.2%	-10.7%	0.3%	-0.2%

Rural

	NET CHANGE	BIRTHS	DEATHS	EXPAND.	CONTRCT.	INMIG.	OUTMIG.
Northeast	-2.3%	5.4%	-13.2%	13.6%	-8.2%	0.3%	-0.2%
North Central	1.4%	6.6%	-12.7%	15.9%	-8.5%	0.3%	-0.2%
South	1.2%	7.4%	-13.9%	15.6%	-8.0%	0.4%	-0.2%
West	7.7%	10.4%	-14.8%	21.6%	-9.6%	0.3%	-0.2%

Source: Allaman and Birch, Components of Employment Change for Metropolitan and Rural Areas in the United States by Industry Group, September, 1975.

Table 4

Status of Firms vs Employment Gains by Region, 1969-72, 1972-74, 1974-76

Births

Percent Employment Gains in firms that are:

	Time Period	Independent	Head Quarters	Subsidiary	Branch/ HQ in State	Branch/ HQ out of State
Northeast	1969-72	43.5	6.9	5.8	14.6	29.2
	1972-74	40.8	4.7	4.5	17.7	32.3
	1974-76	29.2	2.5	1.7	28.1	38.5
North Central	1969-72	42.8	6.8	3.8	15.9	30.7
	1972-74	36.1	4.1	3.0	20.0	36.8
	1974-76	25.1	1.8	1.3	30.5	41.3
South	1969-72	39.8	6.0	4.9	12.9	36.4
	1972-74	39.1	4.3	3.2	13.5	39.9
	1974-76	29.7	1.9	1.7	20.9	45.8
West	1969-72	42.2	5.8	4.2	20.2	27.6
	1972-74	46.4	4.2	2.6	21.0	25.8
	1974-76	29.9	2.1	1.3	29.6	37.1

Expansions

Percent Employment Gains in firms that are:

	Time Period	Independent	Head Quarters	Subsidiary	Branch/ HQ in State	Branch/ HQ out of State
Northeast	1969-72	62.9	16.7	4.3	4.4	11.7
	1972-74	55.9	20.6	5.9	5.7	11.9
	1974-76	57.9	21.4	6.8	4.2	9.7
North Central	1969-72	58.2	15.4	3.0	8.1	15.3
	1972-74	55.4	20.8	4.7	6.0	13.1
	1974-76	54.3	21.2	5.0	6.3	13.2
South	1969-72	59.2	13.3	4.8	4.2	18.4
	1972-74	56.0	16.0	5.0	3.7	19.3
	1974-76	54.2	17.4	5.8	4.6	18.0
West	1969-72	60.3	15.8	3.1	7.5	13.3
	1972-74	58.1	21.1	3.8	6.0	11.0
	1974-76	56.7	22.3	4.7	5.3	11.0

Table 5

MOST IMPORTANT SOURCES OF ORIGINAL FINANCING BY METHOD OF BUSINESS ENTRY

Importance of Sources	Start							Purchase							Inherit (or Purchase from Family)						
	Pers[1]	Fri[2]	Banks[3]	Inv[4]	Vent[5]	Govt[6]	Other	Pers	Fri	Banks	Inv	Vent	Govt	Other	Perc	Fri	Banks	Inv	Vent	Govt	Other
1st	59%	9	23	3	0	1	4	40%	11	37	7	0	2	7	2[illegible]%	33	31	1	0	2	3
2nd	17	15	25	4	0	1	2	26	13	22	6	0	0	3	21	16	18	2	1	1	2
3rd	3	5	7	1	0	0	0	7	5	4	1	1	1	1	7	4	9	0	0	0	0
4th	0	1	0	0	0	0	0	0	0	1	0	0	0	0	0	0	0	2	1	1	0
Not Used[7]	21	71	45	91	99	97	94	27	70	37	86	99	97	90	47	47	43	95	97	95	95

[1]Personal Capital
[2]Friends, Relatives
[3]Banks, Lending Institutions
[4]Investors (not Friends or Relatives)
[5]Venture Capital
[6]Any Government Source
[7]Includes 9% no response

Source: NFIB unpublished survey on "How Small Businesses Begin", November 1979

Table 6

Percentage Point Difference in Payroll as a Percent of Gross Receipts Between Firms Annually Grossing $250,000 or More and Selected Other Size Firms - 1972

Gross Receipts (in thousands)	Construction	Manufacturing	Wholesale	Retail	Selected Services
	Industry Sector				
\$200 - 499	4	12	8	--	14
\$1,000 - 4,999	3	4	5	-2	14
\$50,000 - 99,999	-	1	-1	2	10

Source: Developed from *Enterprise Statistics*, U.S. Bureau of the Census, Dept. of Commerce.

Table 7

Contributions and Benefit Charges for Fiscal Year 1975 for Experience-Rated Firms in the State of California by Taxable Wage Interval

1974 Taxable Wage Interval	Number of Employers	Contributions July 1, 1974 to June 30, 1975	Benefits Charged July 1, 1974 to June 30, 1975	Ratio of Benefits to Contributions
$ 1 - 4,999	86,445	$ 7,138,804	$ 9,002,321	1.261
5,000 - 9,999	63,216	11,155,881	15,746,936	1.412
10,000 - 24,999	92,381	33,262,252	49,681,510	1.494
25,000 - 49,999	48,790	37,230,114	60,830,088	1.634
50,000 - 99,999	29,412	45,066,423	81,413,654	1.870
100,000 - 249,999	20,091	67,996,778	130,412,059	1.918
250,000 - 499,999	6,789	50,608,879	103,781,997	2.051
500,000 - 999,999	2,983	44,921,820	91,231,286	2.031
1,000,000 - 2,499,999	1,619	52,367,457	106,371,509	2.031
2,500,000 - 4,999,999	507	33,870,676	66,580,840	1.966
5,000,000 - 9,999,999	243	32,344,755	68,424,316	2.115
10,000,000 - 24,999,999	142	41,116,951	71,979,824	1.751
25,000,000 - 49,999,999	33	21,268,362	37,020,995	1.741
50,000,000 and Over	32	46,275,593	59,289,556	1.281

Source: State of California, Employment Development Department, <u>1976 California Employer Contributions to the Unemployment Fund</u>, Report 515, Sacremento, 1976, p. 104.

Table 8

Weighted Average Experience Ratings for Rated Firms in Wisconsin and New Mexico in Rate Year 1978 by Taxable Payroll Interval and by Weighting Scheme

Taxable Payroll Interval	Wisconsin			New Mexico		
	Taxable Payroll	Taxable Payroll	Firms	Taxable Payroll	Total Payroll	Firms
<$1,000	2.40	2.21	2.25	1.35	1.29	1.40
1,000 - 24,999	2.86	2.72	2.84	1.42	1.36	1.41
25,000 - 49,999	3.06	2.95	3.05	1.47	1.44	1.46
50,000 - 99,999	3.28	3.20	3.27	1.53	1.49	1.53
100,000 - 249,999	3.42	3.40	3.41	1.67	1.65	1.66
250,000 - 499,999	3.65	3.68	3.66	1.73	1.70	1.72
500,000 - 999,999	3.75	3.74	3.75	1.76	1.67	1.77
1,000,000 - 2,499,999	3.66	3.64	3.66	1.70	1.62	1.69
2,500,000 - 4,999,999	3.67	3.63	3.68	1.68	1.64	1.65
5,000,000 - 9,999,999	3.63	3.81	3.67	1.45	1.42	1.47
10,000,000 - 24,999,999	3.02	3.16	3.09	1.72	1.63	1.74
25,000,000 and Over	2.62	3.09	2.71	.90[a]	.90[a]	.90[a]

Source: Wisconsin and New Mexico state ES-204 Reports for rate year 1978.

[a]Only one firm in this size interval.

Table 9

Weighted Average Experience-Rated Tax Rates for Firms in Oregon and North Carolina by Taxable Payroll Interval for All Rates and Excluding Maximum Rates, for Various Years

Taxable Payroll (000's)	Oregon[a]						North Carolina	
	1976		1977		1978		1977	
	All Rates	w/o Max	All Rates	w/o Max	All Rates	w/o Max	All rates	w/o Max
<10	3.11	2.91	3.08	2.90	3.05	2.87	1.76	1.59
10 - 25	3.19	3.05	3.17	3.04	3.14	3.01	1.79	1.68
25 - 50	3.28	3.23	3.24	3.15	3.22	3.12	1.70	1.63
50 - 100	3.37	3.29	3.33	3.25	3.30	3.22	1.74	1.67
100 - 250	3.43	3.36	3.40	3.33	3.38	3.31	1.88	1.82
250 - 500	3.45	3.39	3.43	3.37	3.43	3.36	1.98	1.92
500 - 1000	3.47	3.42	3.47	3.42	3.47	3.40	2.06	1.95
1,000 - 2,500	3.47	3.43	3.43	3.38	3.45	3.40	2.06	1.97
2,500 - 5,000	3.28	3.24	3.33	3.33	3.35	3.31	2.14	2.09
5,000 - 10,000	-	-	-	-	-	-	2.11	2.08
10,000 - 25,000	-	-	-	-	-	-	2.00	2.00
> 25,000	-	-	-	-	-	-	1.83	1.83

Source: State Reports

[a]For Oregon, the taxable payroll interval 2,500 - 5,000 represents all taxable payrolls in excess of $2.5 million.

Table 10

Distribution of Rated Firms by Taxable Payroll Interval and by Tax Rate for Wisconsin, 1978

Tax Rate (%)	All Rated Firms	Taxable Payroll Interval: <10,000	10,000–24,999	25,000–49,999	50,000–99,999	100,000–999,999	1,000,000 and Over
0.0	27	2	0	0	3	5	17
0.5	12,787	8,695	2,865	880	269	78	0
1.0	3,479	1,311	1,148	627	268	124	1
2.0	14,538	4,884	4,233	2,704	1,563	1,103	51
2.5	9,950	2,032	2,459	2,029	1,618	1,654	158
3.0	8,197	1,488	2,008	1,656	1,287	1,583	175
3.5	6,417	1,169	1,688	1,163	925	1,303	169
4.0	3,244	494	749	688	529	702	82
4.5	2,977	617	768	583	420	521	68
5.0	625	199	184	118	70	49	5
5.2	650	275	214	88	50	22	1
5.5	1,861	421	500	348	266	284	42
6.0	1,489	421	386	252	187	221	22
6.2	580	295	172	65	35	13	0
6.5	5,858	1,688	1,506	983	751	856	74
Total	72,679	23,991	18,880	12,184	8,241	8,518	865

Source: ES-204 Report, State of Wisconsin, 1978.

Table 11

Distribution of Rated Firms by Taxable Payroll Interval and by Tax Rate for New Mexico, 1978

Tax Rate (%)	All Rated Firms	Taxable Payroll Interval					
		<10,000	10,000-24,999	25,000-49,999	50,000-99,999	100,000-999,999	1,000,000 and Over
0.6	5,865	2,920	1,614	784	350	189	8
0.9	2,247	523	600	502	337	267	18
1.2	2,078	362	507	449	345	382	33
1.5	1,359	176	319	281	246	307	30
1.8	803	91	174	161	149	204	24
2.1	459	64	114	84	99	122	12
2.4	333	40	83	69	63	74	4
2.7	250	48	54	58	37	49	4
3.0	225	39	57	60	28	40	1
3.3	171	44	48	43	21	14	1
3.6	158	39	44	30	27	17	1
3.9	68	17	19	16	7	8	1
4.2	1,634	785	385	201	116	140	7
Total	15,686	5,148	4,018	2,738	1,825	1,813	144

Source: ES-204 Report, State of New Mexico, 1978.

TABLE 12

Use of ADR Depreciation by Assets Size of Business

Asset Size	Depreciable Assets: All Businesses	Depreciable Assets: ADR Electors	% of Assets under ADR	% of Total Assets in size group
$ 0 - 500,000	87,125,449	552,528	1 %	7.4 %
to 1,000,000	38,796,041	497,657	1	3.3
	125,921,490	1,050,185	1	10.7
to 10,000,000	107,151,343	6,147,522	6	9.2
	233,073,833	7,197,707	3	19.9
to 100,000,000	108,261,700	29,751,392	27	9.2
	341,335,533	36,949,099	11	29.1
to 1 billion	227,099,521	161,479,321	71	19.4
over 1 billion	604,079,152	556,322,277	92	51.5
	1,172,514,206	754,750,697	64%	100.0%

Source: Office of Industrial Economics, Treasury Department; July 14, 1977; based on 1974 ADR data.

APPENDIX A

Table 1

DEMOGRAPHIC PROFILE OF THE RESPONDENTS

Characteristic	Percentages	Number Responding
Maintenance of Accounting Records:		
Owner	26.3	353
Firm's Bookkeeper	20.5	276
Accountant other than C.P.A.	15.3	206
C.P.A.	37.3	501
Other	.6	8
Preparation of Business tax returns:		
Federal Income Tax		
Owner	10.4	139
Firm's Bookkeeper	6.5	87
Accountant-Non C.P.A.	20.6	276
C.P.A.	60.5	812
Other	2.1	28
State Sales Tax		
Owner	29.9	359
Firm's Bookkeeper	29.4	353
Accountant-Non C.P.A.	13.6	164
C.P.A.	25.7	309
Other	1.4	17
F.I.C.A.		
Owner	24.1	309
Firm's Bookkeeper	33.2	426
Accountant-Non C.P.A.	15.7	201
C.P.A.	25.6	329
Other	1.4	18
Unemployment Tax		
Owner	23.3	294
Firm's Bookkeeper	33.3	421
Accountant-Non C.P.A.	15.7	198
C.P.A.	26.3	332
Other	1.5	19
Other Taxes		
Owner	22.9	287
Firm's Bookkeeper	24.8	311
Accountant-Non C.P.A.	15.9	199
C.P.A.	35.0	438
Other	1.4	17
Use of outside Accounting Services:		
Yes	28.7	365
No	58.7	745
Not applicable	12.6	160
Cost of Tax Returns:		
Under $500	35.3	466
$501-$1000	27.7	366
$1001-$1500	11.8	155
$1501-$2500	9.2	121
Greater than $2500	10.3	136
Not applicable	5.7	75
Costliest tax:		
Payroll taxes	44.8	597
Income or Corporate income tax	36.8	490
Property and/or inventory tax	7.4	98
Other	1.1	14
Uncertain	10.0	133
Tax most need of reform:		
Social Security tax (FICA)	51.8	689
Unemployment Compensation tax	14.4	192
Sales or excise tax	1.7	22
Property tax	2.9	38
Business Income tax	16.0	213
Other	.6	8
Undecided	12.6	167

[¶ 2963A]—Continued

subdivision (i) of this subparagraph. However, inventories of materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(c) *Principles for establishing pools for wholesalers, retailers, etc.* Items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. An example of such customary business classification is the department in the department store. In such case, practices are relatively uniform throughout the trade, and departmental grouping is peculiarly adapted to the customs and needs of the business. However, in appropriate cases, the principles set forth in paragraphs (b)(1) and (2) of this section, relating to pooling by natural business units, may be used, with permission of the Commissioner, by wholesalers, retailers, jobbers, or distributors. Where a wholesaler or retailer is also engaged in the manufacturing or processing of goods, the pooling of the LIFO inventory for the manufacturing or processing operations shall be determined in accordance with the rules of paragraph (b) of this section.

(d) *Determination of appropriateness of pools.* Whether the number and the composition of the pools used by the taxpayer is appropriate, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by paragraph (e) of this section which is used in computing the LIFO value of the dollar-value pool. The pool or pools selected must be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446-1. However, see paragraph (h) of this section for authorization to change the method of pooling in certain specified cases.

(e) *Methods of computation of the LIFO value of a dollar-value pool*—(1) *Methods authorized.* A taxpayer may ordinarily use only the so-called "double-extension" method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items, in a dollar-value pool, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns. The use of any so-called "link-chain" method will be approved for taxable years beginning after December 31, 1960, only in those cases where the taxpayer can demonstrate to the satisfaction of the district director that the use of either an index method or the double-extension method would be impractical or unsuitable in view of the nature of the pool. A taxpayer using either an index or link-chain method shall attach to his income tax return

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for the first taxable year beginning after December 31, 1960, for which the index or link-chain method is used, a statement describing the particular link-chain method or the method used in computing the index. The statement shall be in sufficient detail to facilitate the determination as to whether the method used meets the standards set forth in this subparagraph. In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D. C. The taxpayer shall submit such other information as may be requested with respect to such index or link-chain method. Adequate records must be maintained by the taxpayer to support the appropriateness, accuracy, and reliability of an index or link-chain method. A taxpayer may request the Commissioner to approve the appropriateness of an index or link-chain method for the first taxable year beginning after December 31, 1960, for which it is used. Such request must be submitted within 90 days after the beginning of the first taxable year beginning after December 31, 1960, in which the taxpayer desires to use the index or link-chain method, or on or before May 1, 1961, whichever is later. A taxpayer entitled to use the retail method of pricing LIFO inventories authorized by § 1.472-1(k) may use retail price indexes prepared by the United States Bureau of Labor Statistics. Any method of computing the LIFO value of a dollar-value pool must be used for the year of adoption and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner in accordance with paragraph (e) of § 1.446-1 to use a different method.

(2) *Double-extension method.* (i) Under the double-extension method the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions at the two costs are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second total gives the amount of such inventory in terms of current-year cost.

(ii) The total current-year cost of items making up a pool may be determined—

(*a*) By reference to the actual cost of the goods most recently purchased or produced;

(*b*) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(*c*) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or

(*d*) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(iii) Under the double-extension method a base-year unit cost must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base-year unit cost of the entering item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the entering item is a product or raw material not in existence on the base date, its cost may be reconstructed, that is, the taxpayer using reasonable means may determine what the cost of the item would have been had it been in existence in the base year. If the item was in existence on the base date but not stocked by the taxpayer, he may establish, by using available data or records, what the cost of the item would have been to the taxpayer had he stocked the item. If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner,

[¶ 2963A]—Continued

such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base year, he may use the earliest cost which he does reconstruct or establish as the base-year unit cost.

(iv) To determine whether there is an increment or liquidation in a pool for a particular taxable year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool, an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment. The LIFO value of each such increment is hereinafter referred to in this section as the "layer of increment" and must be separately accounted for and a record thereof maintained as a separate layer of the pool, and may not be combined with a layer of increment occurring in a different year. On the other hand, when the end of the year inventory of the pool is less than the beginning of the year inventory of the pool, a liquidation occurs in the pool for that year. Such liquidation is to be reflected by reducing the most recent layer of increment by the excess of the beginning of the year inventory over the end of the year inventory of the pool. However, if the amount of the liquidation exceeds the amount of the most recent layer of increment, the preceding layers of increment in reverse chronological order are to be successively reduced by the amount of such excess until all the excess is absorbed. The base-year inventory is to be reduced by liquidation only to the extent that the aggregate of all liquidation exceeds the aggregate of all layers of increment.

(v) The following examples illustrate the computation of the LIFO value of inventories under the double-extension method.

Example (1). *(a)* A taxpayer elects, beginning with the calendar year 1961, to compute his inventories by use of the LIFO inventory method under section 472 and further elects to use the dollar-value method in pricing such inventories as provided in paragraph (a) of this section. He creates Pool No. 1 for items A, B, and C. The composition of the inventory for Pool No. 1 at the base date, January 1, 1961, is as follows:

Items	Units	Unit cost	Total cost
A	1,000	$5	$5,000
B	2,000	4	8,000
C	500	2	1,000
Total base-year cost at Jan. 1, 1961....			$14,000

(b) The closing inventory of Pool No. 1 at December 31 1961, contains 3,000 units of A, 1,000 units of B, and 500 units of C. The taxpayer computes the current-year cost of the items making up the pool by

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reference to the actual cost of goods most recently purchased. The most recent purchases of items A, B, and C are as follows:

Item	Purchase date	Quantity purchased	Unit cost
A	Dec. 15, 1961	3,500	$6.00
B	Dec. 10, 1961	2,000	5.00
C	Nov. 1, 1961	500	2.50

(c) The inventory of Pool No. 1 at December 31, 1961, shown at base-year and current-year cost is as follows:

		Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1961, inventory at current-year cost	
Item	Quantity	Unit cost	Amount	Unit cost	Amount
A	3,000	$5.00	$15,000	$6.00	$18,000
B	1,000	4.00	4,000	5.00	5,000
C	500	2.00	1,000	2.50	1,250
Totals			$20,000		$24,250

(d) If the amount of the December 31, 1961 inventory at base-year cost were equal to, or less than, the base-year cost of $14,000 at January 1, 1961, such amount would be the closing LIFO inventory at December 31, 1961. However, since the base-year cost of the closing LIFO inventory at December 31, 1961, amounts to $20,000, and is in excess of the $14,000 base-year cost of the opening inventory for that year, there is a $6,000 increment in Pool No. 1 during the year. This increment must be valued at current-year cost, i. e., the ratio of 24,250/20,000, or 121.25 percent. The LIFO value of the inventory at December 31, 1961, is $21,275, computed as follows:

Pool No. 1

	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost *Percent*	Dec. 31, 1961, inventory at LIFO value
Jan. 1, 1961, base cost	$14,000	100.00	$14,000
Dec. 31, 1961, increment	6,000	121.25	7,275
Totals	$20,000		$21,275

Example (2). *(a)* Assume the taxpayer in example (1) during the year 1962 completely disposes of item C and purchases item D. Assume further that item D is properly includible in Pool No. 1 under the provisions of this section. The closing inventory on December 31, 1962, consists of quantities at current-year unit cost, as follows:

Items	Units	Current-year unit cost Dec. 31, 1962
A	2,000	$6.50
B	1,500	6.00
D	1,000	5.00

(b) The taxpayer establishes that the cost of item D, had he acquired it on January 1, 1961, would have been $2.00 per unit. Such cost shall be used as the base-year unit cost for item D, and the LIFO computations at December 31, 1962, are made as follows:

		Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1962, inventory at current-year cost	
Item	Quantity	Unit cost	Amount	Unit cost	Amount
A	2,000	$5.00	$10,000	$6.50	$13,000
B	1,500	4.00	6,000	6.00	9,000
D	1,000	2.00	2,000	5.00	5,000
Totals			$18,000		$27,000

(c) Since the closing inventory at base-year cost, $18,000, is less than the 1962 opening inventory at base-year cost, $20,000, a liquidation of $2,000 has occurred during 1962. This liquidation is to be reflected by reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 1962, is $18,850, and is summarized as follows:

Pool No. 1

	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost *Percent*	Dec. 31, 1962, inventory at LIFO value
Jan. 1, 1961, base cost....	$14,000	100.00	$14,000
Dec. 31, 1961, increment..	4,000	121.25	4,850
Totals	$18,000		$18,850

(f) *Change to dollar-value method from another method of pricing LIFO inventories*—(1) *Consent required.* Except as provided in § 1.472-3, in the case of a taxpayer electing to use a LIFO inventory method for the first time, or in the case of a taxpayer changing to the dollar-value method and continuing to use the same pools as were used under another LIFO method, a taxpayer using another LIFO method of pricing inventories may not change to the dollar-value method of pricing such inventories unless he first secures the consent of the Commissioner in accordance with paragraph (e) of § 1.446-1.

(2) *Method of converting inventory.* Where the taxpayer changes from one method of pricing LIFO inventories to the dollar-value method, the ending LIFO inventory for the taxable year immediately preceding the

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year of change shall be converted to the dollar-value LIFO method. This is done to establish the base-year cost for subsequent calculations. Thus, if the taxpayer was previously valuing LIFO inventories on the specific goods method, these separate values shall be combined into appropriate pools. For this purpose, the base year for the pool shall be the earliest taxable year for which the LIFO inventory method had been adopted for any item in that pool. No change will be made in the overall LIFO value of the opening inventory for that year of change as a result of the conversion, and that inventory will merely be restated in the manner used under the dollar-value method. All layers of increment for such inventory must be retained, except that all layers of increment which occurred in the same taxable year must be combined. The following examples illustrate the provisions of this subparagraph:

Example (1). (i) Assume that the taxpayer has used another LIFO method for finished goods since 1954 and has complied with all the requirements prerequisite for a change to the dollar-value method. Items A, B, and C, which have previously been inventoried under the specific goods LIFO method, may properly be included in a single dollar-value LIFO pool. The LIFO inventory value of items A, B, and C at December 31, 1960, is $12,200, computed as follows:

Year	Base quantity and yearly increments	Unit cost	Dec. 31, 1960, inventory at LIFO value
Item A			
1954 (base year)	100	$1	$100
1955	200	2	400
1956	100	4	400
1960	100	6	600
Total	500		1,500
Item B			
1954 (base year)	300	6	1,800
1955	100	8	800
1960	50	10	500
Total	450		3,100
Item C			
1954 (base year)	1,000	4	4,000
1955	200	6	1,200
1956	300	8	2,400
Total	1,500		7,600
LIFO value of items A, B, and C at Dec. 31, 1960			$12,200

There were no increments in the years 1957, 1958, or 1959.

(ii) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each layer of increment in Pool No. 1 is shown as follows:

STATEMENT
AMENDMENTS TO THE INTERNAL REVENUE CODE
before the
SENATE FINANCE COMMITTEE
by
DUANE D. PEARSALL
April 2, 1980

I am Duane Pearsall, President, Small Business Development Corporation, a small business consulting and investment firm located in Denver, Colorado. Thank you for this opportunity to testify on legislation designed to enhance and preserve the survival of small business.

A personal biography is attached, however it is sufficient to note only that I have been a small businessman for 25 years, founding four companies, one of which was a failure.

The most significant success was Statitrol Corporation, founded in 1963 to manufacture static control devices, using the principle of air ionization. In our attempt to improve product performance, we discovered how to use ionization in the detection of smoke. We soon found there was a need for early fire detection and, after two years of painful development, we became the first U.S. manufacturer to receive an Underwriters Laboratories' listing for a commercial ionization detector. We later introduced the first, low-cost home smoke detector in 1971, which encouraged many manufacturers to participate, and, the development of a $200 million industry. Most important, of course, home smoke detectors are now credited with saving hundreds of lives and preventing thousands of burn injuries each year. Because of our company's success, I received the SBA national award as Small Businessperson of the Year in 1976.

As a result of that exposure, I was privileged to serve at different times on three significant committees, each of which contributed data supporting the need for revisions to our Internal Revenue Code. This, of course, is the only source for the internal generation of capital necessary for the survival of small businesses. These committees included first, the SBA Task Force on Venture and Equity Capital, which submitted its report in early 1977, more commonly referred to as the "Casey Report". Second was the Advisory Committee on Industrial Innovation, the final report of which was dated September, 1979.

The third, and perhaps most important, was a task force chaired by the Chief Counsel for Advocacy resulting in a report "Small Business and Innovation", May, 1979.

Before making specific comments on the various proposed amendments, I would like to ask the Committee's indulgence to first review a few financial characteristics of the overall small business sector of our economy. This may set the stage for a more sensitive consideration of the specific bills addressed in this hearing.

First, referring to the 1977 Casey Report, there was a statistic developed by our research staff that I have not been able to verify. It was reported that the total invested capital in the small businesses (under $50 million in gross revenue) of our country equalled 3.1 times the total capital invested in businesses over $1 billion in gross revenues in 1956. After twenty years, by 1975, total capital invested in the small businesses represented only approximately 77% of that invested in the larger businesses. It seems to me that the changes in industry concentration should be a mighty important characteristic as a basis for Congressional judgements, not only regarding relative tax burdens, but also on costs of regulatory compliance and any other forms of government interference with the free market. With the many expensive government studies giving us more information about such things as penguins than we ever wanted to know, there is conspicuously absent a simple data base on the very power source that keeps our country running -- American business.

The following numbers seem to verify why small business as a sector of our economy, is getting smaller. These figures are taken from a speech presented by the Chief Counsel of Advocacy, SBA, at a Denver conference, September, 1979.

"Quoting 1974 figures and considering total taxes to include federal, state, local, social security, unemployment, insurance and income; it is reported that manufacturing firms with $50,000 to $100,000 in gross receipts, that total taxes as a percentage of their net worth was 30%. For manufacturers with $100,000 to $500,000 in gross receipts - 23.5%; $500,000 to $1 million - 21.3%; $1 million to $5 million - 19.9%; $10 million to $50 million - 16.9%; $50 million to $100 million - 13.6%; and over $1 billion - 11.5%."

On the surface, those numbers are appalling.

Relative to tax credits, he cites the same regressive pattern. With 40 or 50 tax credits granted as incentives by the government, he cited the following relationships. "Under $100,000 in gross receipts, the total credit was 5.8%. For $1 million to $5 million - 6.5%; for $250 million to $500 million - 17.8%; over $1 billion - 61.1% of taxes due are covered by credits. Twelve times as much in tax credits is given to business taxpayers who gross over $1 billion a year as to those who gross under $100,000."

Further quoting another incentive, that is, for a lower cost of capital through tax-free industrial and pollution controls on financing, "Of 1,634 issues of these tax-free bonds through the year 1977, only 69 issues, or 4% were used by corporations with fewer than 500 employees. These 69 issues totalled $460 million or only 2.6% of the total of $18 billion for the 1,634 issues.

From my experience, and I currently serve on the boards of six small companies in the Denver area, the factor of relative debt to equity ratio between large and small businesses is significant. Add today's cost of borrowing to that disproportionate amount of borrowed capital and we can easily project a compounded disaster for hundreds of thousands of small businesses over the next few months.

Having sold my former business to a $2 billion corporation, and serving as divisional president, I had the opportunity to participate in their corporate planning. It is only reasonable that every well-managed major corporation has been planning for a recession, and they are financially ready. On the other hand, I have not seen a small business with under 50 employees that is not stretched out financially in good times, and have little or no reserves. For lack of diversification, their markets are also more vulnerable to a recession. Barring a miracle or some type of emergency measure which will make capital available at 15% interest or less, we should expect to lose 5% of our small businesses, at least a half million, through simply closing their businesses or bankruptcy, within the next six months.

In preparation for this testimony, I have reviewed each of the ten subject bills with one of the more respected local CPA's specializing in small business.

S.2136 - I am pleased with the reduction in percentage at the lowest level from 17% to 15%. The very small businesses need this relief, and more. I do not need to remind the Committee of the report of the White House Conference on Small Business which recommended not only lowering the percentage at the lowest bracket, but also raising the entire scale, reaching the 46% rate at $500,000. Any improvement, however, is a step in the right direction.

S.110 - Depreciation reform is a stimulus to capital formation and therefore a stimulant to productivity. However, when a heavy equipment operator purchased a D-8 CAT ten years ago, and now needs to replace it at a current cost of $100,000, this bill does not seem to go far enough.

S.2152 - Used equipment is just as strong a stimulus to productivity as new equipment. Since small business is the main customer for used equipment, increasing the level to $200,000 is another step in the right direction.

S.2171 - I understand that previous requirements for furnishing a W-2 was often impossible to meet, and this bill appears to be a housekeeping measure.

S.1967 - Establishing a reserve for market-making activities appears to be a means of stabilizing the financial burden of certain underwriters in the over-the-counter market. Witnessing a strong O.T.C. market in Denver, this measure should be helpful.

S.487
S.653 Each of these bills is helpful in attracting private investor capital into small business. Even with these incentives, however, it is extremely difficult to justify small business investments due to a serious illiquidity as compared with blue chip investments. Nevertheless, they are helpful and should be supported.

S.2239 The original qualified stock option was a key factor in allowing my company to attract a capable marketing manager away from a blue chip company. Removal of the qualified stock option in 1976 was a serious blow to any growth-oriented small business. Avoiding the tax burden at the point of exercise opens up opportunities for both the employee and the small business employer. The bill should be supported.

S.1481 - The Small Business Participating Debenture, in my view, is an exciting mechanism that should prove very effective in attracting private investment capital while at the same time allowing the entrepreneur to retain voting control over his company. These characteristics, combined with other features, make this bill the highest priority of all ten. I would predict acceptance and urge its enactment.

In summary, it is difficult to be enthusiastic for legislation that in some cases seems to fall short of what is needed. At the same time, with all of these bills taken as a package, I am most enthusiastic and support their passage.

As a last point, it would seem that Congressional support would be much easier if they could become aware of some of the relationships expressed by Mr. Milt Stewart, and quoted above, as well as having available a better picture of the characteristics of business structure in our economy in the form of current computerized data base.

Thank you for your consideration.

Senator CHAFEE. That completes the testimony. I want to thank every one of you very much for coming. I know you did that at some sacrifice.

I have a statement here which I would like to include in the record.

[The prepared statement of Senator Chafee follows:]

STATEMENT BY SENATOR JOHN H. CHAFEE OF RHODE ISLAND

It's no secret that soaring inflation and a weakened economy are sapping the strength of U.S. industry. It's also no secret that changes in federal tax laws can give industry the muscle it needs to regain that strength.

Laws to accelerate depreciation rates and reduce taxes on small businesses represent the kind of muscle building we need.

This country has serious economic problems. The President and the Congress are now collaborating to balance the federal budget for the first time in twelve years. Inflation is running at double-digit rates. Economic productivity growth has been declining steadily during the last 10 years. Finally, we are running a balance of trade deficit for the fifth year in a row.

We can no longer afford to play a waiting game with inflation and unemployment. These long-term problems need long-term solutions, not quick-fix bandaids. The solutions are changes in the federal tax laws, which will increase productivity, stimulate capital investment and return the United States to its industrial superiority of the early postwar years.

Once a giant in the world economy, the United States now looks like an aging champion whose dominance is threatened by a growing number of shrewd and vigorous competitors. The decline of the dollar in 1978 caused the United States to drop to eighth place last year in a list of the world's wealthiest countries on a per capita basis.

Since 1950, our share of the world's export market has dropped by 50 percent During the same period, America's share of the world's imports rose 27 percent. In 1960, we imported $15 billion of goods; we now import $200 billion. As we import more and more foreign-made goods without improving our export sales, American jobs are in effect being shipped overseas.

It is clear to me and a growing number of my Senate colleagues that federal tax policy must be used more creatively to spur capital investment in U.S. industry. While it is of utmost importance for us to achieve a balanced budget in the near future, a carefully crafted tax cut that stimulates economic growth will help achieve that goal.

Increased capital investment will create more jobs for our rapidly expanding labor force. As it creates better jobs with more efficient tools, it will make U.S. industry and American workers more competitive with their foreign counterparts.

On July 31, 1979, I joined in introducing the Capital Cost Recovery Act of 1979 in the Senate. It provides an accelerated, simplified alternative to the present system of complex depreciation rules. And most importantly, it is equally accessible to both large and small businesses.

The bill calls for a 10-year depreciation for commercial and industrial buildings, a five-year depreciation for business machinery and equipment, and a limited three-year depreciation for automobiles and light trucks used for businesses purposes.

This schedule will enable business to recover the costs of new investments quickly enough to assure that we are providing our work force with the most modern and productive tools available. The capital cost recovery portion of the bill is central to improving our competitive position in the world market. Among leading industrial nations, the U.S. has one of the longest capital costs recovery periods. We cannot continue to save and invest only minimal amounts in our gross national product year after year and expect to advance our position in the world market.

Accelerated depreciation rates have strong support in Congress and from prominent economists who also favor limited personal income tax cuts. Because demand exceeds the ability of industry to produce efficiently, we are sufffering double-digit inflation. It is politically and economically necessary to provide individual tax relief through incentives to save and invest, such as a personal tax exemption for interest income. These individual tax cuts will go hand in hand with tax relief for businesses.

On June 6, 1979, I introduced the Graduated Corporate Tax Act of 1979, calling for an increase of the corporate surtax base from the current level of $100,000 to a new level of $150,000. Current law assesses a graduated tax rate from 17 percent to 40 percent up to $100,000 of a company's profits, at which point the 46 percent rate starts. My bill requires a similar graduated rate on profits up to $150,000, when the 46 percent rate commences.

The resulting tax savings will amount to $8,000 for each company with taxable income of $150,000 or more. While $8,000 may not mean much to General Motors, it could be a great benefit to a small firm in Pawtucket, Hoboken or Des Moines. America's small businesses have contributed not only the country's biggest employment gains during the last decade, but its boldest innovations as well. For these reasons, we should concentrate our tax relief on small businesses.

The $8,000 in savings can be used by the small businessman to hire another worker, invest in new equipment, or expand or update facilities. An $8,000 annual savings can be reinvested to create additional capital to increase productivity. When productivity grows slowly or declines, as it has in the last 10 years, inflation increases. With wages rising while output per hour falls, the cost of producing a given unit of output increases, putting pressure on businesses to raise prices.

My bill is designed to benefit smaller companies with annual taxable incomes between $50,000 and $150,000. In preserving the current tax rates for the lower end of the scale, the bill gives the most help to those firms which have the greatest need.

There are other measures and proposals that will be discussed at today's hearing, such as incentive stock options, the investment tax credit, and numerous depreciation schedule changes. It should not be overlooked that of the top nine issues selected by the small business delegates at the White House Conference on Small Business this past January, five were in the area of tax reform; and reducing the corporate tax rate, and revision of the accelerated capital cost recovery system, ranked priority number 1 and number 2 with the delegates.

Why are these measures especially important for smaller businesses?

Because it is the small businesses which provide most of the jobs in this country. There are millions of smaller firms in the United States—over 36,000 in my State of Rhode Island alone. We count on them for 56 percent of our national private sector employment, 45 percent of the gross national product and over half of our important industrial inventions and innovations.

It will be the smaller businesses that contribute the greatest effort in the area of increased exports, since most of exporting is currently done by the 500 largest corporations.

The enormous potential of our small business community gives us a chance to tackle some of our most severe social and economic problems without setting up more top-heavy government programs.

Let's face the fact that U.S. industry is just not as competitive as it used to be. As we import more and more foreign-made goods without improving our export sales, American jobs are, in effect, being shippped overseas. Let's admit that long-term problems need long-term solutions.

The gains of the small business community in the last few years represent a new awareness on the part of the government—not just of the unique difficulties faced by these companies, but of the importance of small businesses to the American economy.

My message is that with this new awareness we can act, we do have alternatives. We can no longer affort to play a waiting game with inflation and unemployment. By enacting accelerated depreciation legislation, by stimulating capital formation, we will make an important step toward strengthening our economy. And only from strength can we offer our people a better, more fruitful life.

[From the Congressional Record, June 6, 1979]

By Mr. CHAFEE:

S. 1288, A bill to amend the Internal Revenue Code of 1954 to provide a more graduated tax cut rate for corporations; to the Committee on Finance.

GRADUATED CORPORATE TAX ACT OF 1979

Mr. CHAFEE. Mr. President, the problems faced by our Nation's smaller firms deserve special attention and consideration.

Hand in hand with the country's troublesome unemployment problems and, sluggish economic performance has been an increasing inability of our smaller enterprises to raise money for new capital investments. The uncertain state of our economy in the past years and other recent trends in the financial markets have combined virtually to cut off the small business community from outside financing.

Both the individuals and banks who were once willing to risk investing or lending money to new or smaller businesses have turned instead to bigger established corporations which offer less risk.

Consider the devastating decline in the offerings of new equity by small businesses: From $918 million in 1972 to a mere $16 million 3 years later. During that same time, large business offerings actually rose by 50 percent to a total of $41 billion. The reason for the lack of public willingness to invest in small enterprises lies not in the creativity and innovative capacity of small businessmen, but in public policies which work against a fair return on investment.

This alarming trend has accelerated to the point where small companies face a capital shortage estimated at $8 billion a year nationwide. Who can begin a business, much less expand one, when it cannot raise the money? In such a climate, is it any wonder why four out of five new businesses fail and go bankrupt in their first 10 years? Is it surprising to see so many older, antiquated factories in New England and elsewhere going out of business? When you think about it, it is sad but not particularly surprising.

I am not just concerned, however, because small businesses are having trouble making a profit of getting money from the bank. I am concerned because it is the small businesses which provide most of the jobs in this country. There are millions of smaller firms in the United States—over 36,000 in the State of Rhode Island alone We count on them for 56 percent of our national private sector employment, 45 percent of the gross national product, and over half of our important industrial inventions and innovations.

The enormous potential of our small business community gives us a change to tackle some of our most severe social and economic problems without setting up more top-heavy government programs.

I do not believe anyone would dispute the thesis that an essential ingredient of our strength as a Nation is our economic strength. Only from a strong economy will we provide the jobs our workers need, the defense capability to keep us secure, the social and governmental services we should have.

In so many ways our economic performance is tied to our tax laws and other government actions: Deterrants or incentives to increased capital formation, Federal budget deficits, or surpluses, raising or lowering interest rates regulations that enlighten or confuse—all have an impact on our economy.

Government policy must encourage jobs in the private sector, and must help to increase the availability of investment capital. This is crucial if the private sector is going to meet the problems of economic growth and development. Revising national tax policy is key to making this system work at its best.

A recent report of the Congressional Joint Economic Committee stressed that the percentage of GNP going to business investment over the next several years must be higher than in the past decade if the Nation's employment and productivity goals are to be fulfilled.

A strong flow of private investment back into smaller companies must be regained if we are to take advantage of their highly labor-intensive potential. This message is clear.

Toward this goal, I am introducing a bill which I would urge the Finance Committee to study and adopt.

My bill calls for an increase of the corporate surtax base from the current level of $100,000 to a new level of $150,000. Current law assesses a graduated tax rate from 17 percent to 40 percent up to $100,000 of a company's profits at which point the 46 percent rate starts. My bill requires a similar graduated rate on profits up to $150,000, when the 46 percent commences.

The resulting tax savings will amount to $8,000 for each company with taxable income of $150,000 or more. While $8,000 may not mean much to General Motors, it could be a great benefit to a small firm in Pawtucket or Hoboken or Des Moines.

Under my formula, a corporation with $100,000 in taxable income will pay taxes of $23,000. Under current law prescribed by the Revenue Act of 1978, the same corporation would pay $26,750.

Under my formula, a corporation with $125,000 in taxable income will pay taxes of $31,750. Under current law, the same corporation would pay $38,250.

Under my formula, a corporation with $150,000 in taxable income will pay taxes of $41,750. Under current law, the same corporation would pay $49,750.

These savings on taxes could be utilized for new equipment, or used to expand or update facilities.

Also, an $8,000 annual savings can be reinvested to create additional capital. These options are especially important since the U.S. rate of productivity has been declining for the past few years. As we are well aware, when productivity grows slowly or declines, inflation increases. With wages rising while output per hour falls, the cost of producing a given unit of output goes up, putting pressure on businesses to raise prices.

Mr. President, 40 years ago the first $25,000 of a corporation's taxable income was taxed at the lower rates. In 1975, it was increased to $50,000. Meanwhile, in that 40-year period, inflation had gone up 429 percent.

Last year, the Revenue Act of 1978 raised the corporate surtax base to $100,000. However, between 1975 and 1978, inflation increased 19 percent. Add to this the most conservative estimates from the administration which indicate that inflation will increase an additional 25 percent between 1978 and 1980.

While last year's action, which raised the base from $50,000 to $100,000, did much to help correct an unfair economic situation for the Nation's smaller corporations, the current rate is still not compatible with the inflated amounts of taxable corporate income

My bill represents a modest, but important, change to our tax structure. It is designed to benefit smaller companies with annual taxable incomes of between $50,000 and $150,000. By preserving the current tax rates for the lower end of the scale—that is, the corporations with profits of up to $50,000—the bill does not create a climate for more tax shelters, but rather gives the most help to those firms which have the greatest need.

This bill will compliment my depreciation bill, S. 935, the Capital Cost Recovery Act of 1979, by providing businesses with increased capital investment.

I believe that both of these measures will greatly assist smaller companies to remain competitive, increase productivity, and contribute to the best of their ability to a healthy economy.

The consideration of this legislation is of extreme importance to our small business community. It is a strong and reasonable proposal, and I urge my colleagues to support the bill.

Mr. President, I ask unanimous consent that the bill be printed in the Record together with an attached chart.

There being no objection, the bill and table were ordered to be printed in the Record, as follows:

S. 1288

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That, (a) subsection (b) of section 11 of the Internal Revenue Code of 1954 (relating to tax imposed) is amended—

(1) by striking out "30 percent" in paragraph (3) and inserting in lieu thereof "25 percent";

(2) by striking out "40 percent" in paragraph (4) and inserting in lieu thereof "30 percent";

(3) by striking out "plus" at the end of paragraph (4); and

(4) by striking out paragraph (5) and inserting in lieu thereof the following:

"(5) 35 percent of so much of the taxable income as exceeds $100,000 but does not exceed $125,000;

"(6) 40 percent of so much of the taxable income as exceeds $125,000 but does not exceed $150,000; plus

"(7) 46 percent of so much of the taxable income as exceeds $150,000.".

(b) The amendments made by subsection (a) shall apply to taxable years beginning after December 31, 1979.

Rate structure under the Chafee proposal

[In percent]

Income subject to tax:	*Tax rate on income in the bracket*
$0 to $25,000	17
$25,001 to $50,000	20
$50,001 to $75,000	25
$75,001 to $100,000	30
$100,001 to $125,000	35
$125,001 to $150,000	40
$150,001 and over	46

Senator CHAFEE. Thank you very much. The hearings are adjourned.

[Whereupon, at 12:50 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

DONALD J. MITCHELL
[illegible] District New York

Committees:
ARMED SERVICES
SUBCOMMITTEE ON MILITARY INSTALLATIONS
SUBCOMMITTEE ON MILITARY COMPENSATION
[illegible]
SUBCOMMITTEE ON RESEARCH AND DEVELOPMENT
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[illegible]

[illegible]
Utica, New York [illegible]
[illegible]

May 6, 1990

The Honorable Russell Long, Chairman
Senate Finance Committee
2227 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20515

Dear Mr. Chairman:

Enclosed is a copy of a letter I received from Mr. Leighton R. Burns of the Oneida County Bar Association of Utica, New York. Mr. Burns expresses his support of Senate bills S 1825, S 1984, and S 2220.

It is my understanding that your Subcommittee on Taxation held hearings on these proposals on March 24th. I am hopeful that these hearings will continue, and I want you to have the benefit of these comments in support of these measures.

Thank you for your attention to this matter.

Sincerely,

Donald J. Mitchell
Member of Congress

DJM/pm/r

Enclosure

APR 30 1980

Oneida County Bar Association

Leighton R. Burns
President
Samuel D. Hester
First Vice President
Robert A. Bankert
Second Vice President
Richard G. Compson
Secretary
John H. Story Jr
Treasurer
Don P. Murnane
Immediate Past President
Frank J. Nebush Jr
Executive Secretary

Reply to

Bankers Trust Building
Utica, New York 13501

DIRECTORS

Paul Scalzo
Daniel S. Cohen
Raymond M. Durr
Carl J. Cochi
Richard G. Parker
Paul L. Pileckas
Carl DelBuono
John W. Grow
Vincent R. Corrou, Jr

April 24, 1980

Hon. Donald J. Mitchell
2431 Rayburn Building
Washington, D.C. 20515

Dear Don:

The Senate Finance Committee, Subcommittee on Taxation, recently held hearings on March 24, 1980 on three bills relating to estate and gift taxes. Our Bar Association urges you to support these and similar bills. Moreover, I personally feel that the vast number of your constituents would likewise be in favor of such legislation. The following is a brief summary of the substance of these legislative proposals.

Firstly, Senate Bill 1825 increases the unified credit for estate and gift tax purposes from $47,000.00 (1981) to $70,000.00. The increase would raise from $175,625.00 to $250,000.00 the amount of property not taxable under the federal estate tax. The legislation also raises the phase-in period from $38,000.00 to $48,000.00 in 1979 and from $42,500.00 to $58,900.00 in 1980.

Secondly, Senate Bill 1984 would provide an unlimited marital deduction for estate and gift tax purposes and increase the annual exclusion for gift tax purposes from $3,000.00 to $6,000.00. The marital deduction participation requirement for special farm use valuation elections would be repealed and the decedent or members of his family would no longer be required to participate in the operation of the farm or business before the decedent's death.

Thirdly, Senate Bill 2220 provides that the valuation of property used as a farm or other trade and business passing to the surviving spouse or any child would reduce by five percent (5%) for each year during which the spouse or child materially participated in the operation of the farm, trade, or business.

Hon. Donald J. Mitchell
April 24, 1980
Page 2

These bills would apply to gifts made after 1979 and effective for estates of decedents dying after 1979, except for Senate Bill 1825 which provides for its effective date in 1979 or the phase-in period of the unified credit.

We sincerely feel that these proposed estate and gift tax changes would be substantially beneficial to the public and thus would like to encourage you to aid in the passage of such legislation.

Sincerely,

Leighton

Leighton R. Burns

LRB:ab

cc: Frank J. Nebush, Jr.

NATIONAL SMALL BUSINESS ASSOCIATION
NSB Building • 1604 K Street, N.W.
Washington, D.C. 20006 • Telephone (202) 296-7400

THE VOICE OF SMALL BUSINESS

N S B

FOUNDED 1937

STATEMENT OF WILLIAM C. PENICK

ON BEHALF OF

NATIONAL SMALL BUSINESS ASSOCIATION

SUBMITTED TO THE

SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT

SENATE COMMITTEE ON FINANCE

HOLDING HEARINGS ON

TAX PROPOSALS RECOMMENDED BY THE

WHITE HOUSE CONFERENCE ON SMALL BUSINESS

APRIL 1, 1980

"It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise..."

(P.L. 85-536, as amended, Section 2(a), Small Business Act.)

Not affiliated with the U.S. Government

STATEMENT ON CAPITAL FORMATION AND RETENTION PROBLEMS OF SMALL BUSINESS ENTITIES

Mr. Chairman:

My name is William C. Penick. I am a Certified Public Accountant and Managing Director for Tax Policy of Arthur Andersen & Co. I am submitting this statement on behalf of the National Small Business Association (NSB), a multi-industry trade association representing approximately 50,000 small business firms nationwide. We are pleased to have this opportunity to present our views on various tax proposals recommended by the White House Conference on Small Business specifically on important issues involving capital formation and retention for small business entities.

INTRODUCTION

The contributions made by small business entities to the development of our economy and the creation of jobs are well documented and will not be repeated here. With today's extremely high rate of inflation, accelerating interest rates, and difficulties in achieving access to capital markets, the problems of the small business sector in obtaining and retaining capital are acute.

We are pleased that your Committee is focusing on these critical issues by holding these hearings. We are also pleased that the recently completed White House Conference on Small Business included five recommendations relating to capital formation and retention in its top 15 recommendations to be submitted to the President. These represented the items of highest priority in the eyes of participants in the White House Conference.

As we see them, the major areas requiring Congressional attention to assist small business entities in solving their problems are:

1. How can small business entities gain access to existing sources of capital?

2. How can small business entities preserve or retain the capital they now have?

3. What steps can be taken to reduce or eliminate the erosion in available capital caused by inflation?

Others submitting their views at these hearings have covered some of the same recommendations that are of concern to us, and we will attempt to minimize repetition. We wish to cover in our remarks today proposals for:

1. So-called capital gain rollovers of small business investments.

2. The small business participating debenture.

3. In the general area of coping with inflation;

(a) small business inventory concerns,

(b) indexation of income tax brackets and fixed dollar limitations,

(c) accelerating the recovery of capital already invested in business assets, and

(d) expansion of corporate tax rate schedule.

CAPITAL GAIN ROLLOVER PROPOSALS

It is generally believed that U. S. business suffers from a competitive disadvantage with other major industrial nations because of an inadequate supply of capital and our failure to direct available capital to productive purposes. This is reflected by our declining rate of productivity growth, and the alarming trend in our balance of payments.

The Small Business Administration has reported that a decreasing share of new investment capital is being allocated to the small business sector. Fewer absolute dollars available to cover costs that are constantly escalating because of inflation have resulted in an acute shortage of capital available for the creation and growth of small business entities.

Many are concerned about the disappearance of small businesses through acquisitions and mergers and the continuing trend toward concentration of business. Many such mergers are achieved by tax-deferred exchanges of publicly held stock for the stock or assets of closely held businesses. The retiring owner of a small company who wishes his business to continue and maintain its same character of operation after sale often fails to achieve his wishes because of the attraction of accepting stock in a listed company rather than cash in a sellout transaction. It seems fundamentally wrong that a qualified buyer with adequate cash to offer the selling owner actually suffers a competitive disadvantage to a buyer who offers no cash. Our present tax laws in effect create an incentive for the further concentration of business into larger entities.

Several proposals have been offered that would defer the tax now applicable to sales of stock or assets of small business entities, whether operated in corporate, partnership or proprietorship form, as a means to alleviate this problem. These proposals are generally known as "capital gain rollovers," and they take different forms. The common theme, however, is that the seller of a business will not recognize gain on certain types of sales of his business interests, so long as he reinvests the proceeds in qualified assets. His cost basis in the original interests would in effect be transferred over to the interests acquired through reinvestment of the sales proceeds. In each case, the tax otherwise applicable to the sale is deferred until disposition of the replacement assets.

This treatment would then be analogous to the merger of a small company into a larger entity, with the prior owner receiving stock of the acquiring company. No gain is recognized on the receipt of the stock of the acquiring company until and unless it is sold. This treatment is also somewhat similar to that now provided for the sale of a personal residence if proceeds are reinvested in another qualifying residence.

Specific Proposals

Capital gain rollover proposals for small business interests generally cover three types of circumstances and fulfill for each a unique objective. These are:

1. Sale of stock or assets of small business entities with reinvestment of proceeds in other small business entities.

2. Sale of stock or assets of small businesses, with reinvestment of proceeds permitted in any business entities, including large ones.

3. Sale of stock of large business entities, with investment of proceeds in small businesses.

Some proponents of tax-free or, more appropriately, tax-deferred rollovers advocate that all three types of transactions should qualify for rollover treatment. They cite the objectives as follows:

1. Small for small -- Keeps capital in the small business sector, and permits investors who choose to invest in ventures to recycle their funds by extracting them from a matured investment and reinvesting them in a new venture.

2. Small for large -- Provides equal tax treatment whether a retiring owner of a small business sells for cash to his employees, to another company irrespective of size, or to an individual, as opposed to being forced to dispose of his business to a large corporation with publicly traded securities in order to avoid immediate tax. In a broader sense, the "small for large" rollover would tend to ameliorate tax motivated business decisions that lead to the disappearance of successfully operated small businesses from the overall economic scene.

3. Large for small -- Encourages the transfer of capital from the publicly held sector to the small business sector.

The White House Conference on Small Business adopted the rollover concept as one of its top five recommendations. The National Small Business Association endorses the concept of these proposals and urges their adoption by the Congress to meet the objectives discussed above.

THE SMALL BUSINESS PARTICIPATING DEBENTURE

While estimates of our capital needs for the next decade vary, there appears little doubt that a sizable deficiency will exist. It is commonly stated that small business entities provide jobs for between 55 and 60% of our non-public employees.

Although it is often described as labor-intensive in contrast with the capital-intensive characteristics of larger companies, small businesses must attract enough capital to provide employment opportunities. In small businesses, a little capital goes a long way toward keeping U. S. citizens off the unemployment rolls. Yet the Small Business Administration has reported that a steadily decreasing percentage of our total capital investment is being directed to the small business sector. Accordingly, the already serious need for small business capital is becoming more acute each year. Many small business companies have proven records of performance. They can sustain themselves, they offer products or services which can be sold at a profit, and they are often the principal sources of jobs in rural areas, small towns and even in many large cities.

Many of these companies are now faced with a critical need for new sources of funds. If fortunate, they can obtain capital through conventional sources to sustain and enhance their growth. Otherwise, they can merge or sell out to larger companies, they can attempt some type of equity security offering, or they can rely on internally generated funds to provide capital needed for operations. The last and most commonly chosen option becomes a less viable alternative as inflation makes it more difficult to fund needed replacements from the recovery of historical costs of assets already in place.

Problems With Equity Interests

The business community typically equates capital with equity participation. For years, many have taken for granted the infusion of new equity in a small business as the logical answer to its capital needs. But, with the exception of some venture oriented businesses such as those in high technology areas, equity may be inappropriate for the following reasons:

1. Small business entrepreneurs generally look with disfavor on selling equity interests. They are independent individuals who dislike regulations at all levels of government. They wish to maintain the confidentiality of their financial positions and operating results. They do not wish to have others tell them how to operate their businesses, even though occasionally they may need outside counsel. They often view outside shareholders as a threat to their freedom of action.

2. An equity interest in a small company is generally difficult to liquidate at a fair price. From the viewpoint of the investor, with uncertainty of dividends, little or no voice in management, and no established market for securities, the value of a minority equity interest is often only slightly higher than worthless. On the other hand, the outside shareholders of a small, publicly held company may find the market for his shares so thin that its volatility hinders prudent monitoring as well as current evaluation of its worth.

3. In what does a minority shareholder of a small business share? Though they may have "gone public" to the extent that less than 50% of the voting interests have been purchased by outsiders, many small companies are managed in almost the same manner as when they were privately held. Thus, policy decisions are predicated on the same criteria as before, which often are influenced by the tax and financial postures of the principal shareholders. A minority equity owner is often in an unenviable position.

Present Sources of Capital

Banks have traditionally provided capital needed for growth and expansion of small businesses. This is typically in the form of short-term debt secured by receivables, inventory, or plant and equipment. Term loans, for periods of five to seven years, have become increasingly difficult to negotiate particularly for a small business with an inconsistent history of profitable operations. As such loans often utilize all of the available collateral, there is little opportunity for a small business to obtain additional financing when needed, since few investors are interested in unsecured debt.

For reasons discussed above, investment in small business equity securities is similarly rare. A notable exception, in addition to venture oriented high technology companies noted earlier, would be SBIC loans to promising growth companies that carry stock warrants, options, or other conversion privileges.

As neither debt nor equity securities have succeeded in meeting the capital needs of many small companies, it seems logical that small business may need a new investment vehicle, a new security acceptable and attractive to both the investing community and to small business. If so, could incentives be provided through the Internal Revenue Code as a means of stimulating needed capital investments in small business entities?

Proposal for Small Business Participating Debentures.

Senate bill 1481, introduced by Senator Lowell Weicker and co-sponsored by Senators Baucus, Hatch, and Hayakawa, would permit the creation of a hybrid security with both debt and equity characteristics. This security would carry a stated rate of interest, negotiated by the borrower and lender, and could also provide the investor with a negotiated share of profits during the period the

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instrument is outstanding. The instrument would carry a limited term, during which time the holder of the security would have no voice in the operation of the company other than the right to participate to a limited extent in its profits. This is in contrast to stock warrants and rights which effectively, through shares thus issued, participate in earnings after the company has experienced its critical need for funds and has repaid them.

Proponents of this new security, known as a small business participating debenture (SBPD), believe that it would appeal to small businesses seeking capital, because the mechanism will be self-administered, thus avoiding the necessity for approvals, examinations, permits, and other forms of red tape. Similarly, these proponents contend that the cost of money to the borrower -- both the primary stated interest and the premium based on earnings -- should be a tax deductible expense to the borrower.

Following are some of the specific tax aspects of this proposal:

1. The investor would be permitted a graduated capital formation tax credit, somewhat similar to an investment tax credit, in the year of investment, with

the highest rate of credit being allowed for securities of the longest duration. A 3% credit would be allowed for an investment with a six year maturity, 4% for an eight year maturity, and 5% for a ten year, or longer, maturity. Provisions would be required for recapture of a portion of the credit on early dispositions of the securities.

2. The stated interest received by holders of small business participating debentures would be taxed as ordinary income, but the profit participation, or premium portion, would be taxed to the investor as capital gain, consistent with the treatment afforded gain on sales of corporate stock.

3. The investor would be permitted an ordinary deduction on sales of SBPD securities at a loss, consistent with the treatment presently provided for so-called Section 1244 stock.

4. Payments of both stated interest and the profit participation element would be deductible by the issuing company.

5. To concentrate the benefits from this proposal on small business entities, only businesses with a net equity of less than $25 million would qualify for these securities. Furthermore, no qualifying company could have issued and outstanding at one time SBPD's with a face value in excess of $1 million. Either or both of these qualifying criteria could be increased if Congress considers it appropriate to expand the utilization of this concept.

The National Small Business Association is pleased to support the Small Business Participating Debenture proposal, since it would create an investment vehicle, not presently available, that would be attractive to both lenders and borrowers, and should channel more capital funds into small business entities.

IMPACT OF INFLATION ON SMALL BUSINESS ENTITIES

There is general agreement that our current high rate of inflation is the most serious economic problem now facing the country and perhaps the most serious we have faced in recent history. In 1976, the consumer price index rose less than 5%, but this had increased to a 13% level for 1979. Recent increases in the prices of many goods and services have pushed the annualized rate up to nearly 18% for 1980. Indeed, the recent offering by the Treasury Department of five-year notes with an effective rate of over 14% indicates that sophisticated investors anticipate double-digit inflation for the foreseeable future.

During periods of inflation, the present accounting and tax rules for determining business profits do not accurately reflect the current costs of the products being sold. Because of the failure of accounting and tax procedures for determining business income to adequately recognize inflation, both tax and financial profits are overstated and higher income taxes on stated earnings are imposed. This applies not only in the determination of the amount of corporate profit subject to tax, but also for businesses operating in proprietorship or partnership form where the escalation of income levels into higher brackets creates an inflation windfall to the Federal treasury. Businesses often must borrow to replace assets, or must restrict their growth, due to cash flow reductions caused by higher income taxes and the spiraling cost of replacement assets. It is a vicious cycle.

What change can be made in our tax rules to at least reduce the problems of inflation in our tax system? In the determination of business profits, two elements are very important, the determination of inventory costs and the recovery, or depreciation, of capital costs.

Need for Simplified LIFO System

The so-called LIFO provisions (last-in, first-out) have been in our tax laws for over 40 years. They are widely used by large business entities since, through the accounting techniques employed, they tend to match current costs of goods and materials purchased or manufactured against current revenues. Companies not using LIFO, which include the vast majority of small business entities, are in effect required to match lower costs of materials and products against current revenues, thereby reporting higher taxable profits.

The LIFO rules are complex and difficult to implement. Consequently, very few small businesses can cope with them. It is beyond the scope of this testimony to discuss in detail the LIFO complications and suggestions that have been made for reducing them, but several points are worth noting.

Many of the complications in LIFO could be avoided by using an annual index, perhaps the Consumer Price Index or one developed for specific types of businesses, to make the inventory calculations, and make the system more attractive to small business entities. Another proposal, which would be particularly attractive to very small entities, would essentially be to permit companies below a certain size to use the cash method of accounting for inventories. Qualifying companies could charge as expense the costs of materials and products below a fixed dollar level, perhaps $200,000 of inventory per year.

By permitting use of a LIFO type inventory approach on a simplified basis, small businesses would be permitted to enjoy some of the benefits now available primarily to larger companies, that would minimize the impact of inflation on business profits.

Capital Cost Recovery Proposals

In periods of rising inflation, the recovery or depreciation of asset costs becomes critical. If a company wants to remain in business, it must replace equipment that wears out and, if it wishes to expand, it must acquire new equipment at constantly increasing costs. The discussion of this problem has been intense in recent months and is already the subject of a number of specific legislative proposals. We will not dwell on specific proposals to any great extent today, except to note that in our view several important criteria should be considered in evaluating alternative proposals.

With our declining rate of productivity growth, and our loss of competitive ability in relation to other countries, creating an incentive for new plant investment that would modernize productive facilities and tend to increase productivity seems extremely important. Second, our cost recovery systems should be modified to lessen the impact of inflation on the recovery of asset costs. Finally, and an extremely important point to small business entities, we need a simplified system that will be easier to understand and will reduce administrative problems for both taxpayers and the Internal Revenue Service.

Among the specific proposals that have been introduced are the Capital Cost Recovery Act, the so-called 10-5-3 approach (S. 1435 and H.R. 4646), an expanded and simplified ADR system (H.R. 5665), and the Small Business Capital Incentive Act (H.R. 6617). Without endorsing the specific provisions embodied in any of these approaches, we have concluded that the capital cost recovery approach suggested in S. 1435 and H.R. 6617, which is based on arbitrary recovery periods rather than useful lives, more nearly satisfies these criteria than modification of the present ADR system. As has been documented a number of times, the present ADR system is used almost exclusively by large taxpayers and is of little interest to small business entities. Even with simplification and modification changes, it would still remain more complex than the capital cost recovery proposals now under consideration. Whichever method is finally selected, one of the most critical issues facing small business entities today is tax depreciation and cost recovery and we urge that action be taken in this Congress.

Indexation of Tax Brackets and Amounts

As noted earlier, many small business entities are operated in proprietorship or partnership form. Accordingly, their owners are subject to our progressive individual tax rate structure.

In times of high inflation, income levels are artificially increased and push taxpayers into higher brackets, thereby increasing effective tax rates with no corresponding increase in real income. Various estimates indicate that, at inflation rates significantly lower than we are now experiencing, the Federal Treasury is substantially enriched purely because of the inflation creep in individual tax brackets. Assuming modest inflation rates (8% to 9%) for the next five years, the Congressional Budget Office has estimated that individual tax revenues will be increased by about $10 billion for nine months of fiscal 1981 but rising to nearly $120 billion for fiscal 1985.

The same problem exists with respect to many fixed dollar allowances now in our tax system. Provisions that are of particular concern to small businesses, such as the accumulated earnings credit ($150,000), the Section 1244 limitations, the $3,000 gift tax exclusion, and even the exemption levels themselves, have not been adequately adjusted to reflect the impact of inflation.

Accordingly, while indexation as a concept has many alleged advantages and disadvantages, the National Small Business Association urges that this issue be studied by Congress since the present system is simply imposing unlegislated tax increases of increasingly significant amounts on taxpayers.

Expansion of Corporate Tax Rate Schedule

In 1978, Congress changed the graduated corporate tax rate structure to provide lower rates for taxable income below $50,000, and significantly lower rates for income up to $100,000. The National Small Business Association supports the Number 1 recommendation of the White House Small Business Conference that the graduated business tax rate structure be expanded up to a level of $500,000. This seems consistent with the concern expressed above about the impact of inflation on individual earnings, where inflation is pushing taxpayers into higher brackets. This change would be of considerable benefit to small business entities which must rely on internally generated funds, including retained earnings, not only to provide for growth and expansion but merely to remain in business.

CONCLUSION

The National Small Business Association commends this Committee for holding hearings to focus on capital formation and retention problems of small business entities. The health and vitality of the small business sector is essential to the U. S. economy. It has unique problems that are not faced by large business entities, and special attention must be directed to help solve these problems.

March 28, 1980

Senator Harry Byrd
Chairman, Senate Finance Subcommittee on Taxation
United States Senate
Washington, D. C. 20510

Dear Senator Byrd:

There have been recommendations to your Senate Finance subcommittee on taxation relating to estate taxes of the small business man and farmers. Those recommendations suggested methods to help soften the impact of state taxation at the death of the business or farm owner.

The problem with these recommendations by the National Family Business Council, Inc. and the National Cattlemen's Association is the evident one - "forgive the fact that I failed to plan and then forgive the taxes".

That is not the answer. There are already existing methods which allow the business/farm estate owner to soften the impact of death on taxes. The real problem is that there is no encouragement on the part of Congress or the Department of the Treasury to create action to planning for the ultimate death and tax solutions.

The answer is not to raise the taxable base but to give current tax relief for those who will (and do) plan for the fact of death. The tax relief should be in the form of current deductions for the cost of the plan placed in effect for the conservation of the estate. In this manner more business owners, farmers, and ordinary citizens will be able to afford to plan now for ultimate death taxes and these current plan deductions will actually create less of a drain on national income than raising the taxable base.

The National Cattlemen's suggestion will create relief at the first death but will be disasterous at the second death because of the increased value of the remaining estate. The final heirs, the children, will never be able to sustain the business because the increased estate value at the second death will create the exact same problem as existed originally. Then what do we do - raise the taxable base again?

There should be no threat to family owned businesses and farms and there will be none if the proper incentives are instituted. And, the raising of the base is not the proper method to solve the problem. The proper way is to create the funds necessary, during life, to pay the taxes due at death through a tax incentive method similar in nature to qualified retirement plans on a tax-favored basis.

Respectfully yours,

Thomas A. Damron

Thomas A. Damron, CLU

cc: Senator John Tower
Senator Lloyd Bentson
Representative Jim Mattox

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CABLE ADDRESS: AMFARMBUR

April 11, 1980

Honorable Harry F. Byrd, Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

The Subcommittee on Taxation and Debt Management recently held a hearing on the federal estate tax and its impact on the American family. Two bills in particular, S. 1825, introduced by Senator Gaylord Nelson and S. 1984, introduced by Senator Malcolm Wallop, deal with the effect of estate taxes on family farms and other small businesses. Farm Bureau would like to offer its views on these bills within the context of our current policy on federal estate and gift taxes.

Farm Bureau has long been active in the federal estate and gift tax area because of the effect that these taxes have upon the well being of the nation's farm and ranch families. Farm Bureau was active in its support for estate tax relief in the Tax Reform Act of 1976 and the Revenue Act of 1978. The continuing interest of our three million member families is evidenced in the following policy which was adopted by the voting delegates of the member State Farm Bureaus at the American Farm Bureau Federation's annual meeting in January, 1980.

Federal Estate and Gift Taxes

> "We favor a phase-out of the federal estate tax. Until this phase-out is accomplished, we will continue to support legislation to reduce the impact of the federal estate tax on the orderly transfer of property and an exemption for property on which an estate tax has been paid within 15 years prior to the death of the second decedent.
>
> "We favor recognition of the equal contribution of the spouse to a farming enterprise in estate settlements.
>
> "We favor indexing the federal estate tax to compensate for inflation.
>
> "We believe both crop share and cash rentals should qualify in determining the special use valuation of farmland under Section 2032A of the Internal Revenue Code.

"We favor special use valuation of agricultural land for gift tax purposes similar to the special use valuation of such property for estate tax purposes under Section 2032A of the Internal Revenue Code.

"We encourage a reasonable and flexible interpretation by the Internal Revenue Service of the "material participation requirements" for the special use valuation of farmland under Section 2032A of the Internal Revenue Code."

S. 1825 is clearly supported by Farm Bureau policy. The Subcommittee has received ample testimony on the effects of inflation, and the resulting need to index the federal estate tax to offset it. To adjust the unified credit against estate and gift taxes is a matter of equity to farm families faced with rising production costs, decreasing commodity prices, and inflated land values that bear little relation to productive value. Specifically, Farm Bureau supports modification of the unified credit to increase the equivalent estate tax exemption from $147,333 to $179,000 in 1979, from $161,563 to $213,000 in 1980, and from $175,625 to $250,000 in 1981.

S. 1984 addresses several of the concerns expressed in Farm Bureau policy. Specifically, we support use of an unlimited marital deduction to allow property to pass between spouses free of estate and gift taxes; the use of crop share figures as well as cash rents in the formula for valuing farm land for estate tax purposes under 2032A (e)(7); and a reasonable interpretation of "material participation" for special use valuation under 2032A. Although S. 1984 calls for the elimination of material participation requirements, our policy does not. Complete elimination could encourage abuse by individuals who are not actively engaged in family farming. Other sections of the bill provide tax relief that we believe is necessary to encourage the preservation of family farms.

Farm Bureau members seek complete elimination of the federal estate tax. Until this goal is achieved, we favor legislation such as S. 1825 and S. 1984 to ease the tax burden upon farm families. The goals embodied in these bills are consistent with Farm Bureau policy and we ask that our letter of suppport be included in the hearing record.

Thank you for consideration of our viewpoint.

Sincerely,

Vernie R. Glasson

Vernie R. Glasson, Director
National Affairs Division

American Farm Bureau Federation

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April 30, 1980

Honorable Harry F. Byrd, Chairman
Subcommittee on Taxation and Debt Management
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

Your Subcommittee recently held hearings on a number of legislative proposals that affect tax policy relating to small business. Two of the bills, S. 1435 and S. 110, addressed the issue of depreciation reform. Although Farm Bureau is not offering comments on specific provisions of either bill, we would like to offer our general support for depreciation reform. Any activity that promotes investment incentives by the nation's businesses, particularly small business, benefits the entire economy.

Farm Bureau policy has traditionally supported tax policies that encourage capital formation. We have long supported the investment tax credit as a permanent feature of our tax system and endorsed the capital gains rate reductions contained in the Revenue Act of 1978.

Farm Bureau policy, adopted by the voting delegates of the member State Farm Bureaus at the 1980 annual meeting, states that "tax policy should be designed to encourage private initiative, help stabilize the dollar, promote employment and economic growth, and distribute the tax burden equitably."

Depreciation reform can benefit farmers as well as other small business owners. We encourage the Subcommittee to look favorably upon this concept because it has the potential to promote continued growth of productivity in agriculture and rejuvenate lagging sectors of the economy.

Thank you for consideration of our views. We ask that they be made a part of the hearing record.

Sincerely,

Vernie R. Glasson

Vernie R. Glasson, Director
National Affairs Division

WRITTEN STATEMENT OF
AMERICAN BANKERS ASSOCIATION
HEARINGS ON IMPACT OF FEDERAL
ESTATE TAX ON AMERICAN FAMILY
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

March 1980

In his statement announcing a hearing on the impact of the federal estate tax on the American family, Senator Harry F. Byrd, Jr., Chairman of the Subcommittee, referred to the potential devastating effect that estate and gift taxes may have on family owned businesses and indicated that the hearing would concentrate primarily on S.1825, S.1984 and S.2220. These bills would amend various estate and gift tax provisions. Some of the amendments are "targeted" relief in the sense that they involve family owned business assets while others would provide general estate and gift tax relief.

The American Bankers Association (the ABA) believes that changes are needed in estate and income tax provisions relating to family owned businesses. The ABA also believes that changes are needed in general estate and gift tax provisions. It suggests, however, that considering targeted relief with general relief is not desirable, particularly in the light of the restrictive budgetary constraints Congress is now under.

Accordingly, the ABA recommends that consideration of such subjects as an unlimited gift and estate tax marital deduction (in S.1984), an increase in the annual gift tax exclusion (in S.1984) and an increase in the unified gift and estate tax credit (in S.1825) be postponed and taken up at a later time as part of a review of general estate and gift tax revision, which would include consideration of rate reduction. Significantly, the Senate Finance Committee did not hold hearings on general estate and gift tax changes as a part of its consideration of the Tax Reform Act of 1976. If desired, the general estate and gift tax hearings could be divided into two parts, those involving significant revenue and those which have slight revenue effect.

S.1984 includes changes in section 2032A relating to special estate tax valuation for certain real property, including farms. We agree with some but not all of these changes. Section 2032A needs to be modified. Modifications should not be made piecemeal, but rather in a single project related solely to this section. We recommend that the Subcommittee schedule a hearing devoted exclusively to section 2032A. At that hearing all

63-769 O - 80 - 52

aspects of this provision could be considered, including changes proposed in S.2266, which would increase the income tax basis of property where an additional tax has been imposed by section 2032A(c), and in S.1859 and S.2201, which like S.1984 would amend the formula method of valuing farms under section 2032A to permit crop share rentals to be used where there is no comparable land leased on a cash rental basis. The Treasury Department in its testimony before this Subcommittee on March 4, 1980 objected to S.1859 and S.2201 unless the denominator of the formula used is changed to equal the greater of four percent or the annual rate of return on equity from farm property. The change proposed by the Treasury is inappropriate. We would like an opportunity to state the reasons for our views at a public hearing.

We also urge this Subcommittee to hold a hearing on other targeted estate tax relief for family owned businesses, such as is contained in S.2220, with emphasis being placed upon changes (i) in sections 6166 and 6166A, relating to the deferral of the payment of estate tax attributable to closely held business interests, and (ii) in the interest rate on the deferred tax. In its testimony before this Subcommittee on March 24, 1980, the National Cattlemen's Association referred to the desirability of making changes in these areas, as did other witnesses. S.2309 would reduce the interest rate on deferred estate tax from the current twelve percent rate and merits serious consideration.

During the past ~~several~~ months the ABA has been working on a project involving the "merger" of sections 6166 and 6166A into a single section which would also be changed to be more useful to estates consisting of closely-held business interests. The latest draft of a memorandum discussing the suggested changes is attached to this statement. One of the changes responds to the problems that have been created by interest on estate tax to be deducted in computing this tax.

An important question which should be discussed at the suggested hearing is whether estate tax relief for a special type of property -- an interest in a closely-held business -- is desirable. If the decision is to create such relief, the ABA believes it should be done in a simple and straightforward manner rather than by a new set of technical requirements. This could be accomplished by using as the point of departure the deferral provisions of section 6166. Relief could be granted by forgiving a percentage of the interest and/or deferred tax payments as the payments became due. At the requested hearing, the ABA will explain the forgiveness concept in more detail.

April 1, 1980

MEMORANDUM OF AMERICAN BANKERS ASSOCIATION

Re: Sections 6166 and 6166A and Related Matters - Proposals for Change

A. Introduction

The operation of §§6166 and 6166A, relating to the deferral of the payment of estate tax attributable to an interest in a closely held business, is troublesome in a number of respects. In addition, other statutory provisions add to the liquidity problems of, or create other problems for, a decedent's estate which consists of one or more interests in closely held businesses. The purpose of this memorandum is to discuss the sources of concern and make recommendations for change. In considering these recommendations, we would emphasize that the deferral provisions do not reduce taxes but only extend the period of payment. As a result, we believe the proper approach is to broaden the application of these provisions.

Each of these sections permits an executor to extend the time for payment of the estate tax attributable to closely held business interests, including farms. The amount of the tax that may be deferred in payment is the net federal estate tax payable times a fraction having a numerator equal to the value of the closely held business interest and a denominator equal to the decedent's adjusted gross estate, viz., the gross estate reduced by "allowable" §2053 and 2054 deductions. Payments are made in equal annual installments over a ten year period. The term "interest in a closely held business" is defined differently in each section. Qualification requirements are imposed by each section.

B. Differences Between Sections 6166 and 6166A

Sections 6166 and 6166A contain significant differences which include the following:

1. Section 6166 has a higher percentage qualification requirement - 65 percent of the decedent's adjusted gross estate - than §6166A - 35 percent of the decedent's gross estate or 50 percent of his taxable estate.

2. Section 6166 provides for a five year moratorium on the payment of the estate tax attributable to the closely held business. Section 6166A contains no moratorium.

3. A four percent interest rate applicable to the estate tax attributable to the first $1,000,000 of value is available for deferrals under §6166 but not for deferrals under §6166A.

4. The definition of "interest in a closely held business" is more liberal in §6166. Compare §6166(b)(1)(B)(ii) and (C)(ii) with §6166A(c)(2)(B) and (3)(B).

5. Under §6166(b)(2)(B), stock or a partnership interest held by a husband and wife as community property or as joint tenants, tenants by the entirety

or tenants in common is treated as owned by one shareholder or partner. Section 6166A contains no provision dealing with this matter.

6. Section 6166(b)(2)(C) contains a constructive ownership rule where a corporation, partnership, estate or trust holds an interest in a closely held business. Section 6166A contains no such rule.

7. Section 6166(b)(3) provides that for purposes of the 65 percent requirement an interest in a closely held business which is in the business of farming includes an interest in residential buildings which are used by persons engaged in the farming operation. No similar provision is in §6166A.

8. The aggregation rules for interests in more than one closely held business are more liberal under §6166 than under §6166A. Compare §6166(c) with §6166A(d).

9. Under §6166(g)(1)(A), a disposition of one-third or more in value of the eligible interest will accelerate the payment of the deferred tax whereas the figure in §6166A(h)(1)(A) is one-half or more.

10. Under §6166(g)(1)(D) transfers of property from a trust created by the decedent are not considered as a disposition for purposes of accelerating the payment of the deferred tax. No such statement is made in §6166A(h)(1)(D) and the contrary result could occur.

11. The "undistributed net income" rule of §6166(g)(2)(A) refers to any taxable year of the estate ending on or after the due date of the first installment but the same rule in §6166A(h)(2)(A) refers to any taxable year after its fourth taxable year.

C. "Unifying" Sections 6166 and 6166A

The existence of two deferral provisions with differing requirements creates confusion and in some cases requires an executor to make a choice when all facts necessary to make an informed decision are not available. Considerable simplification would be achieved by "merging" the two sections. This approach was contained in H.R. 4694, introduced by Representative Fisher in 1979 and captioned the "Carryover Basis Simplification Act of 1979." The consolidation would be achieved by using §6166 with the changes referred to in part D below.

D. Suggested Changes in Unified Approach

1. Post-Death Interest as an Administration Expense under Section 2053

The Service now recognizes that post-death interest (including estate tax interest) allowable as an administration expense under applicable state law is a proper estate tax deduction under § 2053. Rev. Rul. 79-252, IRB 1979-34 at 11. When the interest is claimed as an estate tax deduction, the estate tax is reduced. Uncertainty exists as to the amount of the tax because it depends upon the amount of interest, which with deferral under §6166 or 6166A may not be finally determined until many years after the decedent's death.

In order to prevent an estate tax deduction for interest in excess of the amount actually paid, the Service has allowed the deduction only as interest is paid and required the executor to file a protective estate tax refund claim for future interest that may be paid. As interest is paid, the refund claim is allowed for the paid amount, with interest also being paid on the refund. The existence of multiple refund claims attributable to the same estate is complex and time-consuming. Further, this procedure is contrary to the purpose of the deferral provisions - since future interest is not allowed in computing the estate tax the annual installments are overstated and are not in equal amounts as required by the statute.

The effect of the Service paying interest on the estate tax refunds attributable to the interest payments made by the estate is to give the estate an undiscounted deduction for future interest payments. Stated another way, although interest is not paid until several years after the decedent's death, the full amount is still allowed as an estate tax deduction, as are all expenses of administration. This result seems questionable.

The problem is more difficult and significant than indicated above. The threshold percentage qualification requirement under §6166 is related to post-death interest that is paid because this section applies the percentage against an amount that is reduced by deductions that are "allowable" (not allowed) under §2053. The same result may occur under §6166A if the percentage qualification requirement relating to the taxable estate (rather than the gross estate) is used since, in arriving at the taxable estate, "allowed" §2053 deductions are subtracted. All post-death interest is "allowable" under §2053 although it may not be used (allowed) as an estate tax deduction. Thus, at the time an election must be made under §6166 or 6166A, the executor may not know whether the estate is eligible for deferral because the answer will depend upon how much interest will be paid in the future.

Also, in some cases a decedent may have a surviving spouse and make full use of the maximum marital deduction by a formula provision. When this occurs, the amount of the deduction (and the amount included in the surviving spouse's estate) will depend upon the amount of post-death interest claimed as an administration expense under §2053. How is the amount includible in the surviving spouse's gross estate determined when that spouse dies during the estate tax deferral period used by the decedent's estate and interest after the spouse's death may be involved?

One approach to solving the post-death interest problem would be to deny post-death interest as an administration expense under §2053. This solution is unsatisfactory because it is unfair. In many cases, the interest paid cannot be used fully as an income tax deduction since it exceeds the gross income of the estate reduced by other deductions other than the distribution deduction. The likelihood of such a result is increased by a high interest rate. From February 1, 1980 through January 31, 1982 this rate will be 12%. Also, use of the interest as an income tax deduction may create distortion in the interests of different beneficiaries because the benefit of the income tax deduction reduces the taxable income of beneficiaries who do not bear the burden of the interest payment.

We believe a simple solution exists to the post-death interest problem. The denial of an estate tax deduction for the interest should be combined with a grant of forgiveness of the interest at a stated rate and with a lower threshold percentage qualification requirement to reflect the "loss" of the interest deduction. The forgiveness rate would be the highest estate tax rate applicable to the estate, which would be the benefit to the estate if the interest were claimed as an estate tax deduction. Since the forgiveness does not occur until the interest becomes payable, the estate does not get the benefit of a current estate tax deduction for a future payment as occurs under current law. The estate would, of course, still be able to pay the "full" amount of all or any part of the interest and use that amount as an income tax deduction.

An example may be helpful in indicating how the forgiveness approach would operate. Assume that an annual interest payment on the unpaid balance of the deferred tax was $15,000 and that the estate's marginal estate tax rate was 39%, applicable to taxable estates of between $750,000 and $1,000,000. The executor could secure a forgiveness of 39% of that part of the $15,000 which was not claimed as an income tax deduction. If the executor claimed $5,000 (of the $15,000) as an income tax deduction, the payment of interest would be $11,100 ($5,000 + 6,100).

As noted, the forgiveness would be based upon the rate schedule in §2001(c), which is applicable in determining the tax before the allowance of credits. Except for the state death tax credit, the credits are rarely applicable. With respect to the state death tax credit, we believe the correct result is that the forgiveness should be based upon the "gross" federal tax.

The method of computing the forgiveness is the same as that contained in HR 4694 to determine the basis increase for death taxes attributable to appreciation.

When a marital bequest has been funded pursuant to a maximum marital deduction formula provision, use of the marginal estate tax rate to compute the forgiveness may be said to overstate this amount because, after making allowance for the marital deduction, the taxable estate is reduced by ony one-half of the amount of the annual interest payment whereas the forgiveness percentage applies to the entire amount of this payment. However, such an analysis fails to take into account that the amount passing to the surviving spouse is "overstated" and will produce an "additional" estate tax at the spouse's death. These two factors offset each other and collectively are a fair result and certainly one that is preferable to current law.

The suggested approach does not interfere with applicable state law regarding whether estate tax interest is chargeable to income or principal and whether, if the interest is taken as an income tax deduction, an equitable adjustment must be made from income to principal.

2. Threshold Percentage Qualification Requirement

In combining §§6166 and 6166A, H.R. 4694 used the threshold percentage qualification requirements of both sections, thus creating a threefold test of (1) 65 percent of the adjusted gross estate, (2) 35 percent of the gross estate or (3) 50 percent of the taxable estate. The special 4 percent interest rate on the estate tax attributable to the first $1 million of value was available only if the estate met test (1).

Tests (1) and (3) are troublesome because, as noted in subpart 1 above, qualification may depend upon the amount of post-death interest "allowed" or "allowable". This problem is eliminated by excluding post-death interest from consideration. However, without more, such a change would or might increase the threshold requirement if (1) or (3) were used. To avoid this result, the percentages in (1) and (3) should be reduced. A reduction from 65 percent to 50 percent in (1) and from 50 percent to 40 percent in (3) seems appropriate. Use of a 50 percent requirement would achieve conformity with section 303. See discussion below of §303. If these changes are made, consideration should be given to eliminating test (2). The likelihood of an estate satisfying this test but not 40% of the taxable estate is remote.

3. Limitation on Amount of Deferred Payment

Section 6166(a)(2) limits the amount of estate tax that may be deferred which, as noted above, is determined by multiplying the estate tax (after credits) by a fraction having a numerator equal to the value of the closely held business interest and a denominator equal to the adjusted gross estate as defined in §6166(b)(6). Thus, this limitation is uncertain whenever the amount of post-death interest is uncertain. The post-death interest allowable as an estate tax deduction reduces the denominator of the fraction and therefore increases the percentage of the tax deferred in payment.

As in the case of the threshold requirement, the solution is to remove the interest from consideration by modifying the definition of "adjusted gross estate" in §6166(b)(6) to exclude post-death interest.

4. Holding Company Qualification

The present position of the Service is that stock of a holding company cannot "qualify" under §6166 or 6166A unless this company operates a trade or business. Thus, the holding company's ownership of another company which does operate a trade or business is ignored, and form may prevail over substance. Such a result is unsound. A holding company may be required to maintain the differing equity interests of branches when shifting such interests from an older generation to a younger generation.

Section 6166(b)(1) should be modified to provide in effect that the indirect ownership rule of §6166(b)(2)(C) applies for the purpose of determining whether the holding company operates a trade or business. If the holding company owns 20% or more of the voting stock of another company operating a trade or business, this trade or business should be attributed to the holding company for the purpose of determining whether the holding company is operating a trade or business.

5. Acceleration of Payment of Deferred Tax

a. Undistributed Net Income Rule

Sections 6166(g)(2) and 6166A(h)(2) contain rules applicable to a decedent's "estate" which requires that, for taxable years ending after a stated time, the executor must pay an amount equal to its undistributed net income in liquidation of the unpaid part of the deferred tax before the due date for the income tax return of the estate covering such year. If the executor fails to make the payment, the entire unpaid portion of the deferred tax may be accelerated by the Service under §6166(g)(3) or 6166A(h)(3). "Undistributed net income" is defined as the estate's distributable net income for the taxable year, as defined in section 643, reduced by the sum of (i) the distribution deductions under section 661(a)(1) and (2), (ii) the amount of the estate tax (plus interest) paid by the executor during such year.

These provisions create untenable distinctions depending upon what disposition is made of property included in a decedent's gross estate. The undistributed net income rule applies to income on property included in the probate estate but not to income on property included in a revocable trust created by the decedent or to income on property forming a part of a trust created by another person or an irrevocable trust created by the decedent. Thus, the rule is meaningless as to non-probate property.

Also, the rule is of limited significance for probate property when interest on the deferred tax is claimed as an income tax deduction because such interest will reduce the estate's distributable net income. Why should the application of the rule vary depending upon whether this interest is claimed as an income tax deduction or an estate tax deduction?

Some states follow the federal lead and permit the state death tax attributable to a closely-held business to be deferred and paid in installments. In such situations, a distinction should not be made between the federal and state tax for purposes of the undistributed net income rule and, in addition, use of the income to pay the state income tax should not be "penalized."

To summarize, in its present form the undistributed net income rule is unsound. It should be modified to meet the points mentioned above, or preferably, be eliminated.

b. Section 6166(g)(1)(D) and Distributions from Trusts

Section 6166(g)(1)(D) should be amended to substitute the words "a trust included in the decedent's gross estate" for "a trust created by the decedent." A marital deduction trust may be included in a decedent's gross estate but will not be created by the decedent. No policy reason exists why in such a case a distribution of trust property should accelerate the payment of the estate tax on the closely held business interest.

c. Conformity with Section 303

Section 6166(g)(1)(B) states that where a §303 redemption occurs during the deferral period the redemption proceeds are not treated as a disposition of an interest in, or a withdrawal from, the closely held business, which may cause a loss of the deferral privilege, so long as payments of federal estate tax at

63-769 O - 80 - 53

least equal to these proceeds are made on or before next installment becomes payable. This is an all or nothing rule, with compliance causing the entire amount of the redemption proceeds to be treated as a disposition and a withdrawal. The result should changed so that only the amount in excess of the "permitted" §303 payments is treated as a disposition.

Sections 303 and 6166 are also "out of phase" because redemptions under §303 for state death taxes (including interest) and funeral and administration expenses are not protected from acceleration under §6166. Section 6166(g)(1)(B) should be revised to protect all §303 redemptions where amounts equal to the proceeds are used before the next installment becomes due for state death taxes (including interest), funeral or administration expenses and income taxes resulting from the redemption.

d. Distribution of Indebtedness

A distribution of indebtedness by a corporation or a partnership in return for a "qualifying stock or partnership interest is, under §§6166 and 6166A, treated as a distribution or withdrawal in determining whether payment of the deferred tax is accelerated. Section 6166(g) should be modified to eliminate this result as suggested in Recommendation No. 1979-6 of the Tax Section of the American Bar Association. See 32 Tax Lawyer 1464 (1979). This recommendation was approved by the House of Delegates of the Association earlier this year. With closely held business interests, distinctions between indebtedness and equity are inappropriate.

e. Coordinating Withdrawals and Dispositions

Acceleration of the deferred tax may be caused by a withdrawal from the business or as a result of a disposition of the estate's interest in the business. The withdrawal test is based upon the value of the business. See §§6166(g)(1)(A)(ii) and 6166A(h)(1)(A)(ii). The disposition test applies to the estate's interest in the business. See §§6166(g)(1)(A)(i) and 6166A(h)(1)(A)(i). In each case the percentage is the same, one-third (§6166) or one-half (§6166A). The differing treatment of withdrawals and dispositions should be eliminated as suggested in Recommendation No. 1979-6 of the Tax Section of the American Bar Association and approved by the House of Delegates of the Association earlier this year. See 32 Tax Lawyer 1464 (1979). The report on the Recommendation states:

"It is proposed to eliminate the disparate treatment which now exists between the withdrawal and disposition tests by eliminating the withdrawal test as an independent test and by making withdrawals subject to the same limitations as are applicable to dispositions. The disposition test would be further amended to prevent acceleration to the extent that the consideration received in the disposition consists of obligations of the closely held business, since such obligations are not likely to be marketable except at a substantial discount. It is proposed that such a transaction not be considered a disposition that would trigger acceleration. However, the obligations would then in effect take the place of the original interest in the business, so that a subsequent disposition of the specified percentage of the obligations would trigger acceleration."

f. Certain Tax-Free Reorganizations

Acceleration of the deferred tax occurs under §6166(g)(1) if more than one-third of the value of the closely held business interest is "distributed, sold, exchanged or otherwise disposed of". Section 6166(g)(1)(C) provides that an exchange of stock in some but not all tax-free reorganizations described in §368 is not subject to the acceleration rule. See Treas. Reg. §20.6166-3(e)(2). All reorganizations described in §368 should be exempted from this rule, provided the stock received in the reorganization satisfies the definition of "non-readily-tradeable stock" in §6166(b)(7)(B) or indebtedness is received in a company whose stock is so defined. Such a rule would be consistent with the result under §303 when a tax-free reorganization occurs. See §303(c).

6. Qualification as a Proprietor

Section 6166(b)(1)(A) defines an "interest in a closely held business" to include "an interest as a proprietorship." During the past year, Service personnel have asserted that the activities of a manager or agent will not be imputed to a decedent in determining whether the requirement of §6166(b)(1)(A) has been satisfied. In the self-employment tax area (qualification for social security coverage and liability for tax), courts have held that material participation may occur through agents and employees. Harper v. Flemming, 288 F.2d 61 (4th Cir. 1961); Henderson v. Flemming, 283 F.2d 282 (5th Cir. 1960); Foster v. Celebrezze, 313 F.2d 604 (8th Cir. 1963). See also Rev. Rul. 64-32, 1964-1 Cum. Bull. 319. Prior to the enactment of §6166 (now §6166A) in 1958 the Service acknowledged that material participation in farming could be accomplished through agents. Treas. Reg. §1.1402(a)-1(b)(2); Rev. Rul. 56-22, 1956-1 Cum. Bull. 588. Thus, a reasonable assumption is that Congress intended to permit agency relationships to be used in determining whether a trade or business was involved for purposes of §6166. The fact that in 1974 Congress changed the self-employment tax to exempt farm owners whose material participation in farming was attributable to activities of agents (PL 93-368) should not be interpreted as evidence of a Congressional intent to "read" this change into §6166. Further, such a position would create an undesirable distinction between a sole proprietorship and a partnership or corporation owning a farm. If a partnership or corporate holding is involved, the agency activities would be recognized because §§6166 and 6166A refer to the partnership or corporation carrying on a trade or business.

The legislative history of any changes in §6166 should state the intention of Congress that the activities of agents and managers shall be taken into account in determining whether the test of §6166(b)(1)(A) is met.

7. Husband and Wife Holdings

Section 6166(b)(2)(B) directs that stock or partnership interests which are community property of a husband and wife or are held by husband and wife as joint tenants, tenants by entirety or tenants in common shall be treated as owned by one shareholder or partner. This rule is not applicable to interests owned individually by a husband and wife or their estates. Thus, the form of ownership for a husband and wife may cause a difference in result under §6166. This seems inappropriate, particularly when the interest of one spouse was received from the other spouse through a transfer which is includible in the other spouse's gross estate under §2035. A single rule which treats individual holdings of a husband and wife or their estates as owned by one shareholder or one partner is desirable and consistent with the result for subchapter S corporations under §1371(c).

8. "Interest in Closely Held Business" Changes

We believe three changes should be made in the definition of an "interest in a closely held business" which would improve the operation of §6166.

a. "Small" Shareholders

Our members have often represented estates of shareholders in a company where no market exists for the shares but neither the voting stock nor shareholder requirement can be satisfied. For example, the decedent may own 3% of the outstanding stock of a company having 50 shareholders. When the value of the stock satisfies the threshold percentage requirement of §6166, deferral should be available. This may be done by expanding the definition of an "interest in a closely held business" to include any stock of a corporation which has no market on a stock exchange or in an over-the-counter market at the decedent's death. This test is used in §6166(b)(7).

b. Partnership Interests

In order for a partnership interest to qualify as an interest in a closely held business the decedent must have at least 20% of the total capital interest if the partnership has more than 15 partners. Partnership profits may be shared in a manner different from the partners' capital interests. Section 6166(b)(1)(B)(i) should be broadened to permit a 20% interest in partnership profits to qualify as an interest in a closely held business. Many provisions of the Code do not distinguish between an interest in capital or profits. See §§318(a)(2) and (3), 544(a)(1) and (2), 554(a)(1) and (2), 707(6)(1) and (2) and 1563(e)(2).

c. Corporate or Partnership Indebtedness

Corporate or partnership indebtedness owed to a decedent whose stock or partnership interest meets the requirements of an interest in a closely held business is not considered a part of the business in applying §6166. While a distinction between debt and equity interest may be appropriate for income tax purposes, we believe such a distinction is unwarranted for purposes of §6166 when the decedent has a substantial interest in the company. Further, in the case of a corporation, a distinction between indebtedness and preferred stock seems inappropriate. Indebtedness should be included as part of an interest in a closely held business when the 'qualifying" stock or partnership interest (exclusive of the indebtedness) satisfies the threshold 50% requirement.

9. Two or More Interests

A special rule is contained in §6166(c) and §6166A(d) which permits interests in two or more closely held businesses to be treated as a single interest. In order to satisfy this rule, each interest must have a value equal to a stated percentage of the total value of each such business. This percentage is 20 in the case of §6166 and 50 in the case of §6166A. The test is different from the threshold percentage requirement in §6166(b)(1)(B)(i) or (b)(1)(C)(i) and the corresponding provisions in §6166A. This "dual" test for each interest may cause in an interest which alone qualifies for deferral to lose this qualification when combined with another interest. Such a result is undesirable. Further, the 20% test introduces a valuation issue which may not be resolved in the federal estate tax proceeding. Unless the decedent owns 100% of the corporation or partnership, a determination of the value of the entire business will not be made. The special "combination" rule should be changed to use the same tests contained in §6166(b)(1)(B) and (b)(1)(C), namely, that each interest which satisfies the percentage or numerical test will qualify provided the value of all such interests exceed the threshold qualification requirement.

10. "Contemplation of Death" Additions

Treas. Reg. §20.6166-2(c)(1) states

> "it is not necessary that all the assets of the partnership or the corporation be utilized in the carrying on of the trade or business"

Concern has been expressed that this regulation may permit the addition of liquid assets to a partnership or corporation for the purpose of securing a tax deferral with respect to such assets. This concern could be eliminated by having the legislative history of the §6166 changes approve of a restriction on Treas. Reg. §20.6166-2(c)(1) which would be substantially the same as the limitation in §341(e)(7) stating that a contribution will be ignored "if it appears that there was not a bona fide business purpose for the transaction in respect of which such amount was received."

11. Chapter 13 Tax

Section 2621(b) states that §§6166 and 6166A shall not apply to the Chapter 13 tax imposed on certain generation-skipping transfers. We believe this policy decision is untenable. The Chapter 13 tax is a substitute for an estate tax. In almost all other respects, including the application of §303, the Chapter 13 tax is "conformed" to the estate tax. See §§2602(c) and (d) and 2614. No reason is given in the Chapter 13 legislative history for excluding the application of §§6166 and 6166A.

On the other hand, §303(d) contains a special rule for Chapter 13 transfers which is broad and difficult to justify as a policy matter. If a Chapter 13 transfer occurs at or after the death of the deemed transferor §303 will apply provided the value of the stock included in the transfer equals or exceeds 50% of the value of the transfer. Thus, if the trustee has a discretionary power to distribute principal after the deemed transferor's death and the transfer does not occur at death, the trustee by selection of particular property to be distributed (the stock) may assure the application of §303(d) because the remaining trust property is not taken into account in applying the 50% qualification test.

The answer lies in applying §6166 to some Chapter 13 transfers and to restrict the application of §303(d) to the same transfers. The "protected" transfers should be taxable terminations occurring at or after the death of the deemed transferor, which is in general the test under §2602(d) for the application of the alternate valuation method to Chapter 13 transfers.

12. Attribution Rules

The Revenue Act of 1978 contained the so-called "Gallo Wine amendment" which applies the family attribution rules of §267(c)(4) in determining eligibility under §6166 in terms of the shareholder or partner number test or the percentage of capital interest or voting stock requirement. These rules attribute ownership between brothers and sisters but not between spouses of brothers and sisters and descendants of deceased brothers and sisters. As a result, the order of deaths of brothers and sisters may be crucial and the last to die will not have the benefit of attribution which was available to the first to die. Such a result seems unwarranted. Attribution should be permitted from spouses of brothers and sisters and descendants of deceased brothers and sisters.

In addition, attribution should not be lost as a result of the death of a family member. Stated another way, estates of members of a decedent's family should be covered by §6166(b)(2)(D).

13. Section 2032A Property

This section permits certain real property, including farms, to be valued for estate tax purposes in accordance with a special valuation method that produces a value less than its fair market value. The lower value must be used in determining whether the estate qualifies for deferral under §6166 or 6166A. As a result, an estate may be forced to choose between using §2032A and §6166 or 6166A. We believe forcing such a choice is undesirable and inconsistent with the purposes of these provisions. Section 6166 should be amended to use the fair market value of §2032A property in determining whether the threshold percentage requirement is satisfied.

14. Judicial Forum for Resolving Qualification Disputes

Neither §6166 nor §6166A deals with the issue of how a dispute between an estate and the Service concerning whether the estate satisfies the qualification requirements of the section. Revenue Procedure 79-55, IRB 1979-48 at 20, states that if such a dispute arises the estate may request technical advice from the National Office, but if the advice is negative, the estate appears to be without a forum to dispute the determination. A judicial forum should be available to an estate in such a case. We believe this may be accomplished by treating the additional amount of tax claimed by the Service as an asserted estate tax deficiency.

15. Unfunded Bequests

At death, a decedent may be entitled to receive property from an estate or trust which may include an interest in a closely-held business. For example, a husband could die owning such an interest and leave his surviving spouse by will a pecuniary bequest in an amount equal to the maximum marital deduction and the wife could die shortly after her husband and prior to the funding of the marital deduction bequest. In such a case, the determination of whether the wife's estate includes an interest in a closely-held business depends upon whether the executor of the husband's will distributes the interest in satisfaction of the marital bequest. The wife's estate should be entitled to treat such interest as included in the estate for purposes of applying §6166 to the extent that the interest is distributed to the estate. In determining the amount of the deferred tax, the interest would be valued as if it were included in the decedent's gross estate.

E. Suggested Changes in Related Provisions

1. Alternative Minimum Tax

If a taxpayer's adjusted itemized deductions, as defined in §57(b), exceed 60% of his adjusted gross income, the excess is treated as a tax preference and subject to the alternative minimum tax imposed by §55. Thus, to the extent that interest on deferred estate tax is claimed as an income tax deduction, an alternative minimum tax "problem" may exist. The application of this tax to interest on any death tax is inappropriate and inconsistent with the policy behind §§6166 and 6166A. The alternative minimum tax should be modified to eliminate interest on any death tax as an adjusted itemized deduction. Consideration should also be given to eliminating interest on any tax as an adjusted itemized deduction. We have never heard or seen a satisfactory explanation ~~as~~ to why such interest should enter into the computation of the alternative minimum tax.

2. Section 303

This provision provides a safe haven from dividend treatment for the redemption of stock in an amount equal to the decedent's death taxes and interest thereon, funeral expenses and "allowable" administration expenses under §2053. A literal reading would permit "double dipping" in the sense that the interest on death taxes could be claimed twice, once as interest under §303(a)(1) and again as an administration expense under §303(a)(2). The section should be revised to prevent this result. The question then arises as to whether the §303 amount should reflect interest on death taxes and, if so, how the problem of the redemption occurring prior to the payment of future interest should be handled.

Under current law, §303 could apply when the decedent's estate is not eligible for deferral under §6166 or 6166A with respect to the estate tax attributable to the asset being redeemed. This could occur because (1) the threshold percentage requirement is higher under the deferral provisions than under §303 or (2) the asset does not qualify under §6166 or 6166A but does qualify under §303. As to (1), the threshold percentage requirement suggested in part D above would eliminate the disparity. As to (2), a policy decision is required concerning whether §303's broader coverage should be continued. We believe it should be. The redemption may occur before the

§303 amount has been finally determined. If the redemption occurs and its amount plus all prior redemption amounts as to which §303 protection is asserted exceeds the protected amount already paid, the shareholder should be required to file the "final" figures with the Service and waive the application of the statute of limitations for a stated period after these figures are so supplied.

Another simplification could be achieved by modifying the aggregation rule of §303(b)(2)(B) to conform with the aggregation rule of §6166(c).

Finally, "conforming" changes to proposed §6166 should be made in §303(a)(2) and (b)(2)(A)(ii) to exclude post-death interest in determining the amounts "allowable" as deductions under §2053.

3. Sections 302 and 318

Closely-held stock included in a decedent's gross estate may fail to qualify under §303. In such a case, §302(b)(3) permits a redemption to be treated as an exchange (capital gain) if it is in "complete redemption of all the stock of the corporation owned by the shareholder." The constructive ownership rules of §318(a) are applicable in determining whether a complete redemption has occurred. Section 318(a)(3) provides that stock directly or indirectly owned by a beneficiary of an estate or trust is deemed owned by the estate or trust. The Tax Court has held in two cases that an estate or trust may file an agreement under §302(c)(2) waiving family attribution, with the result that a waiver by the estate or trust and a beneficiary prevents attribution to the estate or trust through the beneficiary. Lillian M. Crawford, 59 T.C. 830 (1973); Rodgers P. Johnson Trust, 71 T.C. 941 (1979). These decisions should be "codified" by amending §302(c)(2) to refer specifically to an estate or trust as a "distributee".

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March 27, 1980

Senator Gaylord Nelson
221 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Nelson:

In view of your interest in Small Business Legislation, may I suggest that your Committee look into raising the ceiling on accumulated earnings above $150,000.00. The ceiling is not adequate.

The original ceiling established by Congress was $60,000.00 in 1954. In 1958 Congress increased the ceiling to $100,000.00.

The "Tax Reduction Act of 1975" increased the ceiling to $150,000.00. This is where it now stands.

There are two serious deficiencies in the law.

(1) In effect, it only applies to small corporations. Certainly General Motors can justify retaining more than $150,000.00.

(2) The retainage allowance has completely failed to keep up with inflation.

Utilizing the U.S. Department of Labor Handbook on Labor Statistics, the 1980 amount equal (approximately) to the original 1954 figure would be $173,000.00. The amount to 1980, based on the increase since 1975, would be $192,000.00.

Running a small business with adequate capital is extremely difficult; without adequate capital, it may be impossible.

I would suggest a 1980 ceiling (if any is required) of $250,000.00 with annual C.P.I. adustments.

Let me know your view.

Sincerely yours,

DAVY ENGINEERING CO.
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Philip S. Davy

PSD:wt

American Stock Exchange Inc.

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Arthur Levitt Jr
Chairman

April 18, 1980

Mr. Michael Stern
Staff Director
Senate Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Hearings Before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance (March 28 - April 1, 1980)

Dear Mr. Stern:

I regret that my schedule did not permit me to testify before the Subcommittee on Taxation and Debt Management at its recent hearings on the capital formation problems confronting small businesses today. However, I would like to thank the Subcommittee for giving me this opportunity to comment on the crucial importance to the American economy of providing a vital stimulus for equity investment.

In particular, I ask the Subcommittee to consider supporting S. 655, the Small Business Investment Act, introduced in the first session of this Congress by Senators Weicker, Moynihan, Chafee, Hatch, Nelson and Pressler. This bill would provide tax incentives to individual investors for investment in new equity issues of small and medium-sized companies, thus aiding in the resolution of the critical capital formation problem faced by these companies.

Small business is the backbone of our system of free enterprise. Yet the strain of these inflationary times threatens to weaken the spine, even break the back of small business. The relationship between our rate of inflation and the problems of small business, especially capital formation, is so fundamental and complex that it is hard to separate cause from effect. The numbers are chilling: an annualized rate of inflation of 18 percent; a rate of personal savings at an all-time low of 3.3 percent of income during the fourth quarter of 1979; and a real decline in the standard of living of American families, despite the addition of 2 million workers to the labor force last year.

Small business has a special relevance in the fight against inflation. Economists agree that the principal cause of inflation is our low rate of productivity growth compared to that of our competitors around the world. Today we have the highest percentage of obsolete production facilities of any country in the industrial world. We invest the lowest proportion of our gross national product in capital equipment of any industrial country; and we have the lowest rate of investment in production of any industrialized nation. The list of categories in which U.S.

product superiority is threatened continues to grow. All of this accounts for our low rate of productivity, and it is productivity that can serve as our chief weapon in fighting inflation.

Our ability to compete in the world, to preserve freedom at home and abroad, and to provide the living standards that Americans seek depends upon our capacity to reverse the productivity squeeze and to press the fight against inflation on all fronts. Small business, our nation's engine of innovation, must be the source of this reversal.

But, the capacity of small business to play this role is itself terribly impeded by the effects of inflation. Their chronic shortage of capital -- always a burden to their growth and development -- becomes particularly acute during inflationary times. Capital is more than just the capacity to grow: it is the critical margin that enables small business to survive when the going is rough. And capital is what the small business firm desperately needs. Relief for small business in the form of a real incentive to restore the attraction of investing in American enterprise must become a key component of our broader anti-inflation strategy. Investment in equity capital must be encouraged.

Businesses used to rely on equity capital as a major source of new investment. Today, the situation has changed dramatically. Debt now dwarfs equity financing. Equity accounted for less than 3 percent of all publicly-raised funds in 1977, 1978 and 1979. The debt to equity ratio of American business, particularly smaller companies, has become uncomfortably high, making companies increasingly vulnerable and inflexible. This is not healthy for our economy.

In the last few years, it has become more difficult for small and medium-sized businesses to raise adequate capital through the sale of equity stock. In 1979 businesses raised $7,700,000,000 from public offerings of common and preferred stock, in contrast with a total of $9,778,000,000 raised in 1975. Compounding the problem, in recent years, there has been an increase in the amount of revenue a company needs before it can make a public offering to a minimum of $10 million in revenues.

S. 655 has a two-fold purpose: to provide a significant incentive to invest in smaller companies and to attract individual investors to the equity markets. A credit would be allowed to individuals against their tax liability of 10 percent of investments or $750 ($1,500 in the case of a joint return), whichever is smaller, during the year in new issues of common or preferred stock of small to medium-sized corporations. The credit would be allowed only in the case of new issues by corporations with net equity of $25 million or less.

Utilizing a credit as opposed to a deduction, and limiting credit to a specific dollar amount, would assure that the benefit would flow primarily to the intended recipients, middle income taxpayers. A credit of this type would provide an attractive incentive for investors. It would aid in lowering the towering debt/equity ratios of small companies. The proposal is cost-efficient: it is targeted toward those companies with the greatest need, and the Joint Tax Committee has estimated a revenue loss of only $70 million per year. It would apply only to infusions of capital directly into a company for productive purposes. It would not apply to purchases of shares on stock markets, or purchases of shares in what are called "secondary" offerings made by existing investors in a company.

As Chairman of the White House Commission on Small Business, I was privileged to participate in the meetings, caucuses and discussions all over this country that culminated this past January by bringing 1,600 small business delegates to Washington. The delegates included a tax credit for equity investment of this type among their 15 top-priority measures. This type of proposal has the overwhelming support of businesspeople who are committed to resolving the capital formation problem.

The Amex, of course, has a special interest in the growth of new companies. Our listed companies of the future will come from this pool just beginning to go public. And some of our presently listed companies are just at the beginning of the growth cycle. These companies would greatly benefit from the effects of the credit.

It is clear to me that this credit-for-investment cuts across traditional political lines with a basic appeal not only to smaller corporations and individual investors, but also to labor unions, minority groups, urban leaders and others who are interested in innovation, jobs and economic growth. Their support for this bill is a matter of record.

The American Stock Exchange is deeply concerned with the well-being of America's individual investors, the nation's emerging growth enterprises and the state of our economy. We appreciate the opportunity to make our views known to you.

Sincerely,

March 28, 1980

Mr. Michael Stern
Staff Director
Committee on Finance
Room 2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Stern:

I am writing you in respect to Senate Bill 1984, which would eliminate material participation as a requirement for special-use valuation of farms and businesses.

I am 61 years old and was raised on a farm in Livingston County, Illinois. I have one sister, and we grew up in an area which is not likely to be urbanized for many years. My father started farming about 1919 and farmed until 1959 or 1960. My sister and I grew up on a farm and left the farm to go to school or to be married. When we were young women, the role of women was not as clearly defined as breadwinners as it is now, and thus, I have raised four children. When I was a young lady, it would not have been considered proper for me to become a farmer, even though I was considered the boy of a two-girl family. My mother is still living and is 93. Obviously, it would not have been considered proper for her to be the breadwinner of the family once she was married, which occurred in 1912.

My mother was approximately 90 years old before the special-use valuation provisions of Section 2032A of the Internal Revenue Code was enacted. At age 90, it seemed rather imprudent to say that my mother was a material participating landlord. There may be ways in which, acting as my mother's agent and attempting to work with material participation, where I and my sister would benefit from Section 2032A, but "material participation," as explained to me, appears to be somewhat nebulous and subjective in its possible application.

Had I been a boy or had it been proper for a woman to operate a farm when I was a younger woman or when my mother was a younger woman, we might be eligible for special-use valuation of farm land. As things now stand, it is now entirely possible that my mother will pass away owning 100 acres of land which may be valued at approximately $3,000.00 per acre under traditional methods of valuation. Let us assume she would pass away in 1980. Let us merely say that her personal property would offset any costs of administration and other expenses. Nevertheless, what we would find would be a $300,000.00 estate with a tentative tax of $87,800.00, reduced by the $3,600.00 credit for state death taxes and reduced by the unified credit of $42,500.00, would result in an estate tax of $41,700.00. Had I been a boy and farmed the land or had farmed or managed the land or had it been proper for me, as a woman, to farm or manage the land, under the Section 2032A valuation, the land would possibly be valued at less than $1,000.00 an acre, which would result in no federal estate tax upon my mother's death. Thus, it appears it may cost me and my sister at least $41,700.00 to have been born women.

I still help my mother and manage the farm for her and am attempting to meet the rules on material participation and think that I am. Nevertheless, it seems that the rules in respect to material participation are a sort of a political pablum in an attempt to avoid reality. I am in favor of Senate Bill 1984.

Yours truly,

Betty D. Dyar

Betty D. Dyar

1732 Oakmont Dr.
Decatur, Illinois 62521

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STATEMENT

OF

NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

BEFORE

THE

SUBCOMMITTEE ON TAXATION AND DEBT

MANAGEMENT GENERALLY

OF THE

SENATE FINANCE COMMITTEE

ON

CAPITAL FORMATION INCENTIVES

FOR SMALL BUSINESS

APRIL 1980

Mr. Chairman, members of the Subcommittee, my name is Elmer F. Hechinger, Chairman of the Federal Taxation Committee of the National Society of Public Accountants.

I am the former Director of Revenue for the state of Iowa and am currently an independent accountant in public practice in Altamonte Springs, Florida.

The National Society of Public Accountants is an individual membership organization formed in 1945 and made up of 17,000 small independent accountants in public practice throughout the United States.

The members of NSPA provide the auditing, accounting, tax and management advisory services for more that 4 million small businesses throughout America. According to a recent survey of our membership, a typical client for one of our members is a retail, wholesale, service, farming, dairy, or fishing business. The typical client has less than 25 employees, has a gross income of $100,000 and a net income of $25 to $50,000.

NSPA believes that the two most crucial issues facing small business today is 1) it's inability to get and retain capital for the normal operation of his business and for modest growth and 2) the local, state and federal paperwork, reporting, and record keeping requirements.

While we understand the general need for depreciation reform, participating debentures, stock options, investment incentives, subchapter S reforms and tax-free rollovers, NSPA's experience indicates these capital intensive measures would have little or no effect on the real problems facing the truly small business which is labor intensive.

NSPA believes the need for a simplified tax system (laws, rules, regulations, administration and procedures), an increase in the existing graduated corporate income tax levels and retained earnings exemption and a drastic reduction in the regulatory compliance reporting and record keeping burden will give small business the most immediate and effective relief. However, NSPA would argue that in and of themselves the above mentioned needs would be less effective without a concomitant reduction in government spending and government competition (with small business) for private capital.

Of the bills before the Subcommittee, NSPA would rate S.2136, the Small Business Tax Reduction Act and S.2171 a bill relating to the time when W-2's must be issued to terminated employees as those most conducive to giving small business the most immediate help while having the least adverse revenue impact.

Basically, S. 2136 would increase the upper level of the graduated rate from $100,000 to $150,000. Incomes of $50,000 to $100,000 would be subject to the 30% rate and incomes of $100,000 to $150,000 would be subject to the 40% rate. While we could argue that the levels could be increased to any point or the rates lowered to any level, NSPA believes the relief this bill would provide small business will be significant.

S. 2136 would operate to allow small business to keep more income which would help them finance their operation and growth from retained earnings rather than borrowing. This is especially important to small business in these times of rampant inflation, high interest rates and scarce capital.

NSPA would also urge the Subcommittee to explore the concept of indexing these tax levels to allow for an automatic adjustment for inflation. This would give added incentive to the Government to keep inflation under control for as inflation waxed the federal budget receipts would wane proportionately.

Another related issue to corporate income tax relief is to provide an increase in the exemption for unreasonable accumulation of surplus. The current exemption is $150,000 and NSPA would argue that this exemption should be increased to $500,000, and also indexed for inflation.

Since the tax is imposed primarily on small, closely held businesses, it is applied on the basis of a subjective determination, and is totally beyond the comprehension of the average small business person. Relief in this area would be of great benefit to small business and would have little adverse revenue impact provided inflation was kept under control.

Compliance with government regulation, paperwork, and recordkeeping requirements have a significant adverse financial impact on small business. Moreover, the enforcement of these government requirements disproportionately fall on small business. The paradox is that small business is the least able to cope with these types of expenses, i.e. many small businesses cannot afford an accountant or lawyer just to fill out forms etc..The fallout of this type of bureaucratic oppression has a chilling effect on the small business in relation to accepting or participating in bids on government contracts or expanding their business because their profits are eaten up by administrative expenses related to the government regulation.

As accountants, many of our fees are related to time spent on complying with government reporting and recordkeeping requirements on behalf of our clients. As an example, NSPA did a survey of its membership to determine how much time and cost is directly attributable to local, state and federal reporting and recordkeeping requirements. The results of that survey showed the following:

That NSPA members spend the greatest amount of time and money per month on tax related paperwork requirements. The average time spent on these tax related paperwork requirements was 36 hours at a cost of $37 per hour. The second highest category in terms of time and money is reports/forms. Of these responding to the survey the average time spent on reports/forms is 25 hours at a cost of $24 per hour.

The third highest category is special record keeping requirements. Of those responding to the survey NSPA members spend an average of 16 hours and $22 per hour on special recording requirements per month.

The least amount of time per month is spent on licensing permits and census/survey. The figures for these categories are 5 hours/$23 and 5 hours/$27 respectively.

The average monthly time spent by NSPA members responding to the survey on federal, state and local paperwork is as follows:

	Time	Cost
1. Federal	54 hours	$1442
2. State	21 hours	$ 461
3. Local	10 hours	$ 264

In this regard, NSPA strongly supports S.2171 as a measure that would help relieve some of this unnecessary burden on small business.

Currently, an employee terminated during the calender year must be given a W-2 with his last paycheck or the employer is subject to a $50 penalty for each such failure. However, most if not all must be reissued at the end of the year because of loss or misplacement. In the labor intensive environment in which small business exists, this can be costly.

NSPA conducted a year long study using 100 of our members (two per state) to determine the magnitude and cost of this problem using 15 of their clients as a sample.

The survey yielded the following conclusions:

1. There are approximately 65 million job changes each year (a Labor Department figure);
2. 41% of the respondents did not issue a W-2 to an employee terminated during the year even though they would be subject to a $50 penalty for each such failure;
3. The 59% who did comply sent out about 38.3 million such W-2's each year;
4. Of this 38 million, 66% are lost and must be re-issued at the end of the year. That is, about 25 million unnecessary duplicate W-2's are filled out and mailed annually;
5. The cost of reissuing these forms is estimated at about $12 each, including the time involved, mailing costs and other overhead. This puts the total cost for the 25 million re-issues at about $300 million a year.

The current W-2 consists of an original and 5 copies, comes in sets of 3, and are non-detachable. IRS regulations provide that no erasures or corrections may be made on one if a mistake is made. Therefore an entire set is nullified if a mistake is made on one of the three W-2's. Not to mention the fact that an employer with less than three employees and who need only fill out one or two W-2's of the set is required to send in the other unused W-2 of the set because they are not detachable.

According to our members, in many cases, this cost is absorbed by the accountant or passed on to other clients more able to afford it. The small business cannot.

It is important to note here also that these estimates are based on a 59% compliance factor. If that factor were 100%, the $300 million figure would be in the neighborhood of $625 million dollars. That is a significant expense!

It is readily apparent, that small business, government and everyone else can gain significant cost savings by enacting S.2171. The irony is that S. 2171 would have no adverse revenue impact on the U.S. Treasury!

Mr. Chairman, NSPA strongly urges you and the subcommittee to seriously consider S. 2171 and S. 2136 and recommend their passage this session.

To paraphrase Neil Armstrong, one small step for Congress one giant step for small business.

STATEMENT BY

SHELDON B. LUBAR

PRESIDENT, LUBAR & CO. INCORPORATED

MILWAUKEE, WISCONSIN

TO THE

SENATE FINANCE COMMITTEE

HEARINGS ON CAPITAL FORMATION

ON POLICY INITIATIVES TO FOSTER CAPITAL FORMATION

April 21, 1980

As a Commissioner of the White House Commission on Small Business, my particular responsibility during the past 15 months has been the issues of capital formation and retention. This along with 27 years of experience in banking, investments and venture capital are my qualifications for making this statement. I regret that I was not able to appear in person, but if called upon in the future I will make myself available.

Simply stated, capital is formed through the savings of individuals and businesses. That is all there is to it--nothing more. If a citizen's personal expenditures and tax liabilities are less than his total income, the difference is savings and capital is created. If a business makes a profit after taxes, what is left after dividends to stockholders is retained earnings and again capital is created. All business activity and employment is dependent on the flow and creation of capital.

The problem existing in our country today results from more than 40 years of encouraging consumption and borrowing on the part of our citizens and penalizing savings and investment by means of tax policy. If you question this, then consider that the fruits of typical savings and investments come in the form of interest and dividends. Assume you are a married taxpayer and together with your wife have a total income of $55,000--you could save. However, your 50% earned income bracket means that the interest from your savings are taxed at rates between 50 and 70%. Since most of the saving and investment come from persons in this or higher income levels, not families with say $20,000 of annual income who are barely making it, it is understandable why the savings rate in the United States has sunk to 3%+ of disposable income, the lowest of any developed country. And our declining competitive position with countries such as Germany and Japan, whose citizens save at a 14% rate, also becomes understandable.

Without oversimplifying, the solution to this problem is embodied in three changes in our tax laws:

Eliminate any differentiation between the tax treatment of "earned" vs. "unearned" income. Initially this would mean a top personal tax bracket of 50%.

Reduce corporate taxes, especially those of small business which sector represents the most dynamic portion of our economy. Allow these companies to keep more of their "seed" or retained earnings so that they can build and grow.

Allow for more rapid depreciation of business assets. Our tax laws provide one of the slowest rates of capital recovery in the world. In some countries, business assets can be written off in one year. If we are to improve productivity and compete in a worldwide economy, faster capital recovery is a financial necessity.

Since high levels of inflation and a rapidly escalating cost of living index bear on the feasibility of fiscal measures such as I have proposed, let me briefly comment on these issues.

In recent years the cost of living index has been used by many as the measure of inflation and has confused the issue and the policies necessary to deal with inflation. Inflation results from an increase in the volume of money and credit beyond the real growth of the economy. A balanced budget at the lowest possible level of expenditure will ultimately bring inflation to a halt. Cost of living is an index of a market basket of consumer needs, and hence is a measure of buying power. Therefore, inputs such as higher interest rates feed into this index along with every OPEC increase in oil prices, wage increases of each worker with a cost of living escalator, etc. The cost of living index will stabilize when the budget is balanced at a reasonable level of expenditure, the free market price of energy has worked its way through the economy and the confidence of our people in this country's ability to sensibly grow is restored. Use of this index to escalate wages, government pensions, social security payments, etc. is distortive and unfairly transfers money from tax paying citizens to specially designated recipients.

In summary, sound economic policies take 5 or 10 years to be effective--change is not instantaneous. What is needed today are the tax measures referred to earlier, the discipline of a budget balanced with a restraint on spending and the patience to allow these measures to become effective.

Executive Offices: 13 Temple Street, Quincy, Mass. 02169/Tel: (617) 786-7000/Cable: Patriot — Quincy/Mass.

The Patriot Ledger

April 9, 1980

The Hon. Harry F. Byrd Jr.
Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing you as publisher of an independent, locally-owned newspaper, The Patriot Ledger in Quincy, Mass., which has been a family-owned and operated business for more than 100 years. And, I write in connection with your subcommittee's hearings on S 2220 and other bills aimed at fulfilling the concern expressed by delegates to the White House Conference on Small Business that estate tax laws be revised "to ease the tax burden on family-owned business and encourage the continuity of family ownership."

The American Newspaper Publishers Association's Tax Law Task Force, on which I served as chairman, made a year-long study of federal estate tax laws and agreed that bias exists in those laws which presents formidable barriers to the continuation of independent ownership of newspapers and indeed all kinds of businesses. The Task Force made a number of recommendations in a comprehensive report later approved by the boards of directors of both ANPA and the National Newspaper Association. ANPA is a trade association representing more than 1370 member newspapers and more than 90 percent of U.S. daily and Sunday newspaper circulation. NNA represents some 500 smaller-city daily newspapers and about 5,000 weekly newspapers throughout the United States.

The Patriot Ledger is a member of both organizations and I am a Director of ANPA. The two organizations now have formed a Tax Law Action Group, which I chair, to foster implementation of Task Force recommendations.

S 2220 would exempt from estate taxes up to one-half the value of a family-owned business, but no more than $500,000 in valuation. Mr. Chairman, this ceiling is too low to include many of the independent, family-owned businesses in this country which offer effective competition to larger non-family businesses. If the purpose of the legislation is to preserve individual and family ownership of businesses able to foster growth in productivity, competition and diversity in the nation's economy, then the $500,000 valuation ceiling should be removed.

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The Hon. Harry F. Byrd Jr.
April 9, 1980
page two

In addition, the subcommittee should consider several other constructive steps to assure that federal estate tax laws have no effect on decisions by family business owners to sell prior to the death, and that federal estate tax laws do not force such sales after death.

First, the federal estate tax laws should be changed to allow stock of closely-held businesses and farms to be valued for estate tax purposes on the basis of their present and historic financial condition without regard to sale prices of comparable properties.

Second, the accumulated earnings penalty tax should be eliminated as it applies to accumulations to pay death taxes by designating such accumulations as "reasonable business needs".

And finally, the qualifications tests for both extended time payments of estate taxes and for stock redemptions to pay death taxes should be lowered to enable the estates of more decedents to be eligible for these provisions.

There are other constructive actions which might be taken, but these are the major steps which the members of the Tax Law Action Group believe should have top priority in the deliberations of your subcommittee. I enclose a roster of the Action Group.

If you or members of your subcommittee would like to discuss these provisions or others in further detail, either with me or with staff members of ANPA or NNA, please feel free to do so.

Sincerely,

Scott Low

K. Prescott Low
Publisher

cc: Hon. Lloyd Bentsen
Hon. Herman E. Talmadge
Hon. Mike Gravel
Hon. Bob Packwood
Hon. John H. Chafee
Hon. Malcolm Wallop
Hon. Gaylord Nelson

April 1980

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April 25, 1980

The Honorable Harry F. Byrd, Jr.
United States Senate
Washington, D. C. 20515

Re: Hearings of the Subcommittee on Taxation and Debt Management of the Senate Finance Committee Concerning Small Business

Dear Senator Byrd:

The purpose of this letter is to supplement the testimony given by Association representatives before your Subcommittee on March 28, 1980. In conformity with the format suggested for witnesses at those hearings, our witnesses, William R. Hambrecht and Mason T. New, commented on the following four bills:

- S.653 - The Small Business Capital Preservation Act of 1979;
- S.1967 - The Capital Formation Incentive Act of 1979;
- S.2168 - The Subchapter S Capital Formation Act of 1979; and,
- S.2239 - Incentive Stock Options

In view of our organization's very deep interest in improving the environment for small business financing, we wish to make the following points. First, capital formation is a multifaceted process which involves a continuous interaction of marketplace forces. Because of this, it is unlikely that a solution to the capital-raising problems of small business will be found in one or two congressional initiatives. Rather, what is needed is a comprehensive, well-balanced and coordinated series of initiatives that collectively address this problem. Second, there are a number of meritorious bills, in addition to those listed above, currently pending before your Subcommittee which could form the basis for that comprehensive program of initiatives to aid small business. Several of these bills track recommendations previously made by the NASD Joint Industry/Government Committee on Small Business Financing in its Report entitled, Small Business Financing: The Current Environment and Suggestions For Improvement. This Report, which represented the culmination of many months of research and study by our Joint Committee, included recommendations paralleling the following bills:

- S.110 - The Small Business Depreciation Reform Act - In the NASD's Report, the Association endorsed S.110 with one exception, that being that the $25,000 maximum depreciation

The Honorable Harry F. Byrd, Jr.
April 25, 1980
Page Two

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deduction proposed in this three-year accelerated depreciation bill be raised to $100,000. It is the Association's belief that the $25,000 limitation is too restrictive, particularly in these inflationary times where replacement costs have skyrocketed. Although we believe a limit of $100,000 would be more appropriate, we are of the view that S.110 even without that adjustment represents a step in the right direction.

- S.1435 - The Capital Cost Recovery Act - Subsequent to the introduction of S.110, another depreciation bill, S.1435, was introduced. In sum, the bill would replace existing depreciation rules with a new system of accelerated depreciation by providing a 10-year write-off for plants and buildings, a five-year write-off for machinery and equipment and a three-year write-off for a limited amount of investment in automobiles and trucks. The bill would also shorten the useful life eligibility requirement for the full 10% investment credit from seven to five years and would increase from 3 1/3% to 6% the investment credit allowed assets which qualify for a three-year write-off. Other changes relating to depreciation are also included in the bill.

  Although this bill goes well beyond the recommendation advanced by our Committee (in that its coverage is not aimed primarily at small business), it has been put forth by its sponsors for essentially the same reasons — to promote capital formation and to increase productivity.

  We are aware too of another bill recently introduced in the House, H.R. 6617 - The Small Business Incentive Act of 1980, which would provide for a scheme of accelerated depreciation using write-off periods somewhat different from those in S.1435 and imposing ceilings to limit the impact on the Treasury, i.e., 15 years for buildings and four years for machinery and vehicles with annual limitations of $3 million and $1 million, respectively. S.1435 is essentially an open-ended depreciation measure in that the write-offs available under the bill would be unlimited for most types of property.

  In connection with the above, we must point out that we have conducted no independent study of the impact of either S.1435 or H.R. 6617 (or for that matter, H.R. 4646 - the companion bill in the House to S.1435) and therefore, we do not have our own estimates of their potential impact on the Treasury or the likely distribution of benefits among American businesses and industries. We believe, however, that more liberalized depreciation rules as well as more liberalized eligibility requirements for investment tax credits are needed to revitalize our nation's economy. As the 1979 Report of the Joint Economic Committee and statistics compiled by the Department of

The Honorable Harry F. Byrd, Jr.
April 25, 1980
Page Three

Labor pointed out, the United States now ranks seventh in productivity, capital investment and economic growth among the major free world industrialized nations. Only by stimulating the modernization of plant and equipment can productivity gains be realized and our competitive position in international markets strengthened.

At this juncture, we wish to relay to you our support for the concept of liberalized accelerated depreciation. However, we will leave to persons more knowledgeable in this area than us the formulas and mechanics by which such concepts are to be implemented.

- S.2136 - The Small Business Tax Reduction Act - In its Report, the NASD recommended that the income rates for corporations be further graduated to enable smaller firms to retain a greater proportion of their earnings. The Association recommended that this should be done by both a reduction in the tax rates and an expansion of the income brackets. The NASD proposal was offered in the form of a general recommendation without specific rates or schedules included. S.2136 is consistent with our recommendation in this area and we support its adoption.

In addition to the above, there are a number of other small business bills pending before your Subcommittee. They include:

- S.487 - The Small Business Investment Act of 1979;
- S.1481 - Small Business Participating Debentures;
- S.1825 - Estate Tax Adjustment Act of 1979;
- S.2152 - The Used Machinery Investment Credit Adjustment Act of 1979;
- S.2171 - Elimination of Duplicate W-2 Tax Forms; and,
- S.2480 - The Accumulated Earnings Adjustment Act of 1980

In connection with the above, we must advise that the problems which these legislative initiatives seek to correct were never the subject of study by our Joint Industry/Government Committee on Small Business Financing. Although our Committee's Report included a total of 19 recommendations for improving the environment for small business financing, there were no recommendations contained therein that specifically parallel the subject matter covered by these bills. Consequently, we are unable at this time to offer substantive comments on any of these initiatives. We have, however, circulated copies of each of these bills, together with an explanation thereof, to the NASD member representatives on our Committee for their views and comments. In that connection we hope to provide

The Honorable Harry F. Byrd, Jr.
April 25, 1980
Page Four

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you with their thinking on these proposals on or before April 30, 1980, the date the record for these small business hearings will be closed.

* * *

We hope your Subcommittee finds our supplemental comments on the aforementioned bills helpful. If you, any members of the Subcommittee or any member of its staff desire, we would be pleased to meet with you, the Subcommittee or members of the Subcommittee staff to discuss these comments in greater detail at your or their convenience.

Sincerely,

Gordon S. Macklin
President

WASHINGTON WOMEN FOR THE SURVIVAL OF AGRICULTURE

April 3, 1980
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The Honorable Harry Byrd
Chairman, Sub-Committee on Taxation
Room 2221 Dirkson Building
Washington, D.C. 20510

Dear Senator Byrd:

We have just learned that your Sub-Committee on Taxation had hearings on Estate Tax changes the last week of March. We would like to have our remarks considered during mark-up as they relate directly to Section 2 of S1984, one of the bills considered during your hearings. We would also very much like to have the hearing record, and to be included on your mailing list for future hearings and other information as it relates to estate and gift tax.

The Washington Women for the Survival of Agriculture(WWSA) have long been concerned with what we consider an unfair tax on death, particularly as it relates to husband and wife. As you can see from the enclosed statement, we feel that this partnership should be treated as one unit and taxed only when both partners have died. Whatever the reason for the original taxation on transfers between spouses, inflation has now created a situation that makes continuing a family business almost impossible if one of the principals dies.

The steps that Congress has taken in recent years have definitely helped in passing on these family enterprises and we are most appreciative of these actions. Current use valuation, deferral of payment of taxes, increasing the unified tax credit as inflation continues are helpful. However, they are all very complex manuevers and we feel that they should not be necessary between a man and wife.

Encouraged by the success in our state on being able to start the removal of inheritance tax between spouses, we decided in October of 1979 to try to do the same thing on the federal level. We have sent our position and other information to major national organizations such as the farm groups, Retired Associations, Small Business Groups, all vitally concerned in removing this crushing burden to family owned and operated farms and businessess.

We appreciate your committee's continuing concern with up-dating the federal estate and gift taxes, and hope that our position is seriously considered.

Sincerely,

Dorothy Reid, Tax Chairman

Janet Allison, Legislative Chairman

WASHINGTON
WOMEN FOR THE
SURVIVAL OF
AGRICULTURE

Testimony on Estate and Gift
Tax Changes
To
Sub-Committee on Taxation adn
Debt Management
April 1, 1980

Senator Harry Byrd, Jr., Chairman
Room 2221 Dirkson Building
Washington, D.C. 20510

The Washington Women for the Survival of Agriculture (WWSA) have long been concerned about the unfairness of state and federal inheritance taxes, especially between spouses. In 1979 we were able to get legislation passed in our state to start a phase out of the state inheritance tax between spouses. Montana and Indiana also took major legislative steps to correct this type of taxation. We believe that the same type of revisions should be made to the Federal Tax Code. We believe that all tax on transfer of property, money, possessions both before and after death should be removed for the following reasons:

(1) Marriage is a unique partnership which is spiritual, legal and economic in nature. Man and wife are united as one in the eyes of God and the laws of our country. Therefore, their property, possessions and money should also be treated as one unit within this marriage contract. This is especially important if this partnership is involved in farming or other small family businesses.

(2) Taxes can break up this unit by forcing the survivior to sell property, equipment, or both to pay these taxes. This can cripple or even end the business or farm, as most equipment, buildings and other capital investments are geared to the size of the economic unit. Also productive businesses usually have few liquid assets available to pay estate taxes.

(3) The farm has historically been the capital unit needed for old age pensions for farmers, small businessmen and their wives. Present Social Security, Keogh and IRA plans are not adequate to fulfill this purpose.

(4) Inflated land values put farm owners and other small businessmen in an unusually vulnerable position on all taxes, estate tax being the final blow. There has been no con-current jump in the production income of farmers and there is no way for a farmer to adjust his operation so that income will increase as much as his land values and taxes have. Therefore, we feel that estate taxes probably pose a greater burden on the surviving spouse of a partnership that is dependent on ownership of property for earning its livilihood.

(5) It is an ultimate cruelty to force a newly widowed person to face complicated legal manuvering and complex paperwork that is now necessary under present laws. In many cases the costs of probate, fees paid for accounting, real estate apprasals, etc. are often more than the estate tax owed, not even counting the cost of original estate tax planning, which can add even more to the cost of settling an estate, but no taxes.

(6) Estate and gift taxes were never intended as major revenue raisers, but as a means of breaking up very large estates. This is not working now as these people are able to avoid most of these taxes by plans worked out by lawyers, accountants or financial managers. These devices bring more income to these advisors, but not much revenue, and the value of an estate can be depleted by the expense involved. Meanwhile, the tax now hurts the small businessman, farmer and other property owners. Inflation has now placed many persons who have regarded their worth as very modest into the tax category where the trust route or incorporation is the only way to continue as economic unit. These methods have strong drawbacks in the operation of a farm or business.

(7) Estate Taxes have a deletorious effect on the economy. This money is money taken from the private sector, decreasing money available for investments in business, production and income. Increased production, on the other hand, is available when the economic unit is left intact. This continued or increased production contributes to the economic strength of our country, creating more jobs and incidently generating more income taxes as income is maintained or increased.

(8) Finally, we believe that the fiscal impact on total revenues collected by the Treasury will not be as great as some think because:

(a) If the marital unit is not taxed upon the death of the first spouse, it is not a total avoidance of this tax. The tax in the long run stands a chance of being as much or more on the second spouse's estate as the unit would probably be valued as much and possibly more. This increase is possible because of the graduated tax rates and possibly higher estate tax rates.
(b) Revenue from income tax on a marital unit left intact after the first spouse dies will undoubtedly increase, as the unit will be the same size or larger, generating more income tax again due to graduated rates and the loss of one dependent as a deduction.
(c) Many people now going thru complex and costly tax avoidance schemes such as family trusts, incorporation and foundations would probably not do so if one spouse was able to keep the marital unit intact without this initial tax. This means the possibility of some revenue generated that is not now available, as many people would choose to pay a moderate estate tax than enter into these time consuming, costly and complex schemes.

We hope that this committee will seriously consider our position. We have received a surprising number of letters from all across our country, in response to a national magazine article, that indicate very strong support for the removal of this particular death tax.

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SECURITIES INDUSTRY ASSOCIATION
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EDWARD I. O'BRIEN
President

May 27, 1980

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation and
Debt Management Generally
417 Russell Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

We would like to take this opportunity to express our support for S. 1967 - which would permit securities market makers to defer taxes on gains from their market making activities on behalf of small businesses.

SIA represents about 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on investment decisions by corporations and investors.

As institutional investors become more and more critical to capital markets, their behavior and performance with respect to small business issues become increasingly important. Institutions' share of common stock ownership has risen dramatically from 26 percent of common stock in 1960 to an estimated 50 percentage by 1985. The NASD Special Report on Small Business Financing reveals that institutional investors are extremely concerned over the marketability of investments in smaller companies. This was the principal reason cited by survey respondents (153 out of 223) as to why they did not invest in companies with a capitalization of less than $50 million.

The impact of these factors upon the amount of capital raised by small companies and the number of these firms able to go to market has been devastating. In five years, 1974 through 1978, only 82 such companies - defined as having a net worth of less than $5 million - were able to raise capital in the public securities markets. That is an average of 16½ per year, compared to 698 in the single year of 1969. During these same five years, these small businesses raised an average of just over $100 million per year in public equity capital compared to over 1½ billion for similarly sized companies in 1969.

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Initial offerings rebounded somewhat in 1979, due largely to a more favorable climate for investment resulting in capital gains tax reductions passed by this committee and Congress in 1978. But initial offerings in 1979 were still less than one-third of those in 1969, and far short of the needs of small business in the 1980's. S. 1967 would attract new broker-dealer participation to market making activities as well as encourage those already engaged to continue their efforts. The availability of tax-deferred reserves would afford a broker-dealer some protection against losses incurred in market making. The use of reserves would recognize the cyclical nature of the securities business. Deferment of taxes on a limited amount of profits in a good year would provide a reserve against losses in a poor year. The unparalleled turbulence of the economy has taken a heavy toll on the independent broker-dealer population and increased the risk involved in such market making activity without increasing the reward for such risk-taking. This bill is a moderate sensible remedy which would cushion the extremes of volatile markets. The use of up to $1 million dollars for a limited amount of time, after which taxes would have to be paid is a small cost for the benefits to be derived.

S. 1967 will have a special impact for precisely those portions of the broker-dealer community most critical to the capital raising ability of small businesses. While all broker-dealers would be eligible for tax deferral, traditionally it has been the smaller, local dealers who have made markets in securities of small issuers and found local investors for those issues. Many local businesses have depended upon the local broker-dealer to bring them public and provide them secondary markets. The shrinkage of the broker-dealer community in the last ten years has hit regional firms especially hard - and consequently has impacted small business most severely. In our opinion this bill is of critical importance to maintaining and enhancing the ability of small business to generate capital, particularly as the number of securities firms engaged in risk market making continues to decline. During this decade, in fact, the number of market makers has fallen about 37% (to 468); so on the average there are fewer than ten market makers per state. In nine states there are none at all, and many other states have but one market maker. Hence large regions of our nation are already suffering from an inadequate capital raising structure for nascent companies. Even more distressing is that this structure continues to deteriorate.

Small companies seeking public financing for the first time stand the most to gain from enactment of this legislation. The key in linking private company and public investor has been the local independent broker-dealer who brings an issue through registration and who stands ready after the initial sale to make a market in that company's securities. Issuer, investor and broker-dealer stand in delicate balance to one another, with the success of each largely dependent upon the other two. Upsetting the balance in recent years has been the decline in the number of both the broker-dealers and individual investors. These declines are paralleled by the precipitous fall-off in the number of new issues brought to market from 649 to 58 annually in the ten year period from 1969 to 1978.

The revenue impact of this measure would be small indeed. The NASD study concludes that for year 1977, using a proposal somewhat broader in scope than S. 1967, a total of 487 broker-dealers market makers would have been able to defer about $20 million in tax liabilities or about $40,000 per firm, on gross revenues from market making in over-the-counter securities of approximately $330 million.

Nor would the proposal result in any windfall to any broker-dealer especially given the $1 million maximum. Benefits resulting from S. 1967 would be directly linked to a firm's level of participation in small business underwritings to improve the depth and liquidity of markets. Correspondingly, market making activities and profits are strictly defined by the SEC and are, as such, readily identifiable under present law. Thus administrative questions do not pose problems for this bill.

This analysis clearly identifies the problem faced today by capital starved small business. Unless the recent trend of decline in the number of market makers can be halted and reversed, most small developing companies will find it all but impossible to raise the necessary funds. In our view, S. 1967 can provide the type of incentive and stimulus which is needed to achieve that reversal. By allowing market makers to set aside gain from their activities, broader and deeper market liquidity will be attained. While broker-dealers benefits are obvious, the benefits to small issuers should prove equally immediate actually in proportion to the tax deferral allowed. The true beneficiary of the alterations mandated by this legislation would be the entire national economy, which will be pushed again towards balance as a result of the resurgence of the small business sector.

Sincerely,

Edward H. O'B