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TAX REFORM PROPOSALS—XII

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 10, 1985

(Agriculture, Timber and Small Business)

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TAX REFORM PROPOSALS—XII

WEDNESDAY, JULY 10, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Wallop, Symms, Grassley, Long, Bentsen, Moynihan, Baucus, Mitchell, and Pryor.

[The press release announcing the hearing and an opening statement of Senator Packwood follow:]

[Press release, Tuesday, June 25, 1985]

TAX REFORM HEARINGS IN FINANCE COMMITTEE TO CONTINUE IN JULY

Examination of President Ronald Reagan's tax reform proposal will continue in July with a series of hearings before the Senate Committee on Finance, Chairman Bob Packwood (R-Oregon) said today.

"We made a good start on the hearing portion of this long process toward overhaul of the Internal Revenue Code during June," Senator Packwood said. "The hearings we have scheduled for July will take us further toward our goal of having a bill to the President by Christmas."

The hearing announced today by Senator Packwood pertains to:

On Wednesday, July 10, the Committee is to receive testimony from public witnesses on the anticipated impact the tax reform proposal will have on agriculture, timber and small business.

OPENING STATEMENT BY SENATOR BOB PACKWOOD, TAX REFORM HEARING ON TIMBER CAPITAL GAINS AND EXPENSING

For years I have worked hard to bring jobs to Oregon. Now, suddenly, I am confronted by a potential loss of thousands of jobs in Oregon by three proposed changes in the tax code that would devastate the timber industry. Those three issues are:

1. The repeal of capital gains treatment for timber;
2. The elimination of the annual tax deduction for fair and legitimate expenses in maintaining timber;
3. The repeal of the 10 percent investment credit and 7-year amortization of reforestation expenses, although the maximum credit available is only $10,000 a year.

The key here is jobs in Oregon. It's one thing to change the tax situation of a healthy, thriving industry. It's something else again to change the rules of an industry that has suffered dramatic setbacks because of:

1. High interest rates;
2. A decrease in housing starts;
3. Competition from wood product imports.

This isn't tax reform. It's the deliberate act of sabotaging an entire industry and thereby the State of Oregon. I am not asking that the industry receive special treatment. All I'm asking is that it be treated equally.

I told the Treasury Secretary, Jim Baker, before the tax reform proposal was submitted that I would do everything possible to kill the unfair timber tax changes in the bill. If I fail in that, I will do everything possible to kill the entire bill. I will not stand by and see the principal industry in my state unfairly singled out and by that act alone causing the loss of thousands of jobs in Oregon.

The CHAIRMAN. The hearing will come to order, please. I would like to call on Senator Symms, who has an opening statement.

Senator SYMMS. Mr. Chairman, thank you very much. I first want to compliment you on the way the entire hearing process has been going on on the President's tax reform proposal.

The CHAIRMAN. Thank you.

Senator SYMMS. I also want to welcome all of our witnesses who will be here this morning. There are two colleagues, Senators Abdnor and Sasser, who will both be here, and then all of the other witnesses. I would only say that I have a great deal of interest in the subject this morning, as does the chairman, but in my State agriculture, timber, and small business make up the bulk of the income in the State. I think there are some parts of the President's tax reform proposal that simply have to be corrected before it can be acceptable to the constituents I represent, and the chairman knows these issues very well and will, I am sure, be interested in those same things also. And I think they can be corrected without doing any serious damage to the overall revenue questions in the bill. In fact, I think that, as far as the environmental questions are concerned, that there is a good reason for those people who like to see trees planted to leave tax incentives in the tax law to encourage people to plant and grow timber. I want to apologize to the witnesses this morning, but I am chairman of the Transportation Subcommittee. We are having hearings on the reauthorization of the Surface Transportation Act, and that series of hearings starts this morning. So, at 10, I will have to excuse myself and leave, but it isn't that I am not interested in what the witnesses will say. I will be watching very carefully and reading their statements and following the hearing record. Thank you very much.

The CHAIRMAN. I will have a statement to make just prior to the timber panel. Senator Baucus.

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

The CHAIRMAN. I think what Steve said applies to all of us when he said agriculture, timber, and small businesses are the backbone of his State. You and I aren't much different. We will start with our colleague, Senator Jim Sasser, the senior Senator from the State of Tennessee.

STATEMENT OF HON. JIM SASSER, U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator SASSER. Thank you very much, Mr. Chairman and distinguished members of the committee. I appreciate the opportunity to appear before you today. I know that you have a full day's witnesses, and as a member of the conference on the budget, I am scheduled to be at the White House, for what I hope will be a happy resolution of this budget dilemma within the next 30 minutes, so I will make my remarks very brief.

First, Mr. Chairman, I wish to commend you for holding these hearings here today. It is enlightening, I think, to seek the counsel of small business leaders on the issue of such great importance to them as tax reform. And I might say that I can speak with some degree of authority on this point since I have chaired field hearings of the Senate Small Business Committee on the impact of the proposed tax reform package. At these hearings, several issues were repeatedly raised as special tax concerns of small business. Conversations with various small business associations illustrated that these concerns were shared at large across the small business community. To address this concensus of concerns on the part of small business, I introduced legislation, S. 1130, containing what I perceived to be the most pressing small business tax issues.

Subsequent thereto, the President unveiled his revised tax reform proposal. Now, at first glance, small business fairs quite well under the President's package. But upon closer examination, it is clear that we can fine tune the administration's proposal in several areas to promote economic growth of small business and to ensure that efforts to simplify the Tax Code extend to small firms as well as giant corporations.

For example, most small business owners were elated that the President's proposal backed away from the suggestion of a flat rate for all corporate taxpayers. By retaining a graduated corporate rate, the administration has addressed the overriding concern of many small businesses. But I am troubled that, while the administration argues persuasively for a tax cut for large corporations, small corporations earning below $50,000 receive no tax break. The argument that we can stimulate economic growth through reduced tax rates should certainly be extended to small firms.

My legislation contains a proposal which does exactly that. Where the President proposes a rate of 15 percent on corporate income up to $25,000 and a rate of 18 percent on income between $25,000 and $50,000, my proposal would lower these rates to 12 percent on income to $25,000 and 15 percent on income between $25,000 and $50,000—in effect, a 3-percent lowering of rates.

Another area where I would submit we can fine tune the President's proposal involves equity financing. With the proposed elimination of the investment tax credit and cutbacks in depreciation schedules, many small business owners fear that we are eliminating all vestiges of equity financing found in the Tax Code. My legislation seeks to allay such fears by allowing greater use of direct expensing than suggested by the President's proposal. The President's proposal to cap the amount that may be expensed at $5,000 does not provide an incentive to invest or at least an adequate incentive to invest, in my judgment. And moreover, the value of direct expensing will diminish under such a cap as the effects of inflation are felt over time.

Simplification efforts can be made in the area of accounting. It seems clear that the President's proposal regarding cash accounting will make this simpler method of accounting unavailable to many small firms. I propose extending the spirit of simplification contained elsewhere in the President's proposal to cash accounting as well.

And finally, Mr. Chairman, in the area of capital gains, I believe that most firms are generally satisfied with the provisions contained in the administration's proposal. The critical point here is maintaining a capital gains rate which promotes continued economic growth.

There are other areas where I believe we can fine tune the President's proposal to better promote both economic growth and simplification, but these are set out in my extended prepared statement, which I will ask unanimous consent, Mr. Chairman, to be included in the record as if read.

The CHAIRMAN. It will be in the record in its entirety.

Senator SASSER. If I may finish on one note, Mr. Chairman. I know well the critical importance of small business to local economies all across this Nation. In my home State of Tennessee, for example, we have some 83,000 business establishments, and roughly 79,000 of these 83,000 business establishments employ less than 100 people. Indeed, 58,000 of them employ 10 or fewer workers. In 1982, these small firms produced roughly one-half of the $50 billion in goods and services produced in my native State. So, small business is clearly big business in this country.

It is our responsibility to ensure that we do not snuff out the creative driving force inherent in these small firms in our worthwhile efforts to reform the Tax Code. These hearings today illustrate that you, Mr. Chairman, and the distinguished members of this committee understand this most important point. Again, I appreciate this opportunity to appear before you and present my views on behalf of small business. Thank you.

The CHAIRMAN. Jim, thank you very much.

[The prepared written statement of Senator Sasser follows:]

STATEMENT OF SENATOR JIM SASSER, TAX REFORM AND SMALL BUSINESS, SENATE FINANCE COMMITTEE, JULY 10, 1985

MR. SASSER: MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO DISCUSS THE IMPACT OF TAX REFORM ON SMALL BUSINESS. ACTIVELY INVOLVING SMALL BUSINESS IN THE DEBATE ON TAX REFORM IS ESSENTIAL TO THE PASSAGE OF ANY SUBSTANTIAL TAX REFORM MEASURE. FOR QUITE FRANKLY, WE NEED THE BACKING OF OUR MAIN STREET BUSINESSES IF WE ARE TO MOVE FORWARD WITH A TAX REFORM BILL. THE PRESIDENT RECOGNIZED THIS FACT WHEN HE SINGLED OUT SMALL BUSINESS OWNERS AND ENTREPRENEURS DURING HIS TELEVISED ADDRESS ON TAX REFORM. HOWEVER, AS YOU AND I KNOW, MR. CHAIRMAN, IT WILL TAKE MORE THAN WORDS ALONE TO ACTIVELY INVOLVE SMALLBUSINESS IN THE EFFORT TO PASS A TAX REFORM PACKAGE.

AS YOU EXPLORE THE SMALL BUSINESS ASPECTS OF TAX REFORM, I BELIEVE YOU WILL FIND THAT SMALL BUSINESS HAS MUCH TO CONTRIBUTE TO THE TAX REFORM DEBATE. I SPEAK WITH A DEGREE OF AUTHORITY ON THIS POINT, AS I CHAIRED HEARINGS OF THE SENATE SMALL BUSINESS COMMITTEE ON JANUARY 9TH IN NASHVILLE AND MEMPHIS, TENNESSEE ON THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS.

I HEARD MANY SPECIFIC RECOMMENDATIONS AT THOSE HEARINGS ON ISSUES SUCH AS DIRECT EXPENSING AND CORPORATE TAX RATES. I WILL TOUCH ON THESE POINTS IN A MOMENT, BUT BEFORE DOING SO I WOULD LIKE TO UNDERSCORE THE IMPORTANCE ATTACHED TO TWO GENERAL THEMES

I HEARD REPEATEDLY AT THOSE HEARINGS. MOST OF THE RECOMMENDATIONS I HEARD CENTERED ON STIMULATING ECONOMIC GROWTH AND FOSTERING SIMPLIFICATION OF THE TAX CODE FOR SMALL BUSINESS. THESE SMALL BUSINESS OWNERS SAW THE REFORM EFFORT AS A GOLDEN OPPORTUNITY TO ACHIEVE THESE TWO IMPORTANT GOALS.

BASED ON WHAT I HEARD AT THESE HEARINGS AND IN CONVERSATIONS WITH SMALL BUSINESS ASSOCIATIONS, I DRAFTED A SMALL BUSINESS TAX REFORM BILL, S. 1130, WHICH SET FORTH WHAT I PERCEIVED WERE THE OVERRIDING CONCERNS OF THE SMALL BUSINESS COMMUNITY IN THE TAX REFORM DEBATE. MANY OF THE PROVISIONS IN MY LEGISLATION WERE ISSUES WHICH EITHER HAD NOT BEEN ADEQUATELY ADDRESSED IN THE INITIAL TREASURY DEPARTMENT TAX REFORM PROPOSAL, OR MODIFIED SECTIONS OF THAT PROPOSAL WHICH WERE PARTICULARLY ONEROUS TO SMALL BUSINESS. SOON AFTER I DROPPED IN MY LEGISLATION, THE PRESIDENT UNVEILED HIS REVISED TAX REFORM PROPOSAL.

AT FIRST GLANCE, SMALL BUSINESS FARES QUITE WELL UNDER THE PRESIDENT'S PROPOSAL. INDEED, THIS PACKAGE IS A VAST IMPROVEMENT OVER THE PROVISIONS CONTAINED IN TREASURY I. YET, UPON CLOSE EXAMINATION IT IS CLEAR THAT THE PRESIDENT'S PROPOSAL CAN BE FINE-TUNED TO BETTER STIMULATE ECONOMIC GROWTH AMONG SMALL FIRMS AND TO ACHIEVE THE GREATEST DEGREE OF SIMPLIFICATION WHICH IS POSSIBLE FOR SMALL BUSINESS.

For example, I applaud the movement away from a flat corporate rate as proposed in Treasury I. Retaining graduated corporate rates for small firms is far and away the number one concern of those interested in small business when discussing tax reform. My legislation recognized the shortcomings in Treasury I's flat corporate rate and set forth a graduated corporate rate structure for small firms. I am pleased that the President's proposal follows this recommendation. Yet, I am troubled that while large corporations will receive a tax cut under the President's proposal, small corporations earning less than $50,000 receive no tax break.

The President's proposal argues for corporate rate reductions as a means of increasing equity investment. I believe this logic should extend to small firms as well. My legislation contains a proposal which does just this. Where the President's proposal recommends a rate of 15% on corporate income up to $25,000 and a rate of 18% on income between $25,000 and $50,000, I suggest lowering the rates on these two categories to 12% and 15% respectively.

Another economic growth issue in the President's proposal which is of concern to small business again involves equity financing. With the proposed elimination of the Investment Tax Credit and cutbacks in depreciation schedules, many small

BUSINESS OWNERS FEAR THAT ALL PROVISIONS IN THE TAX CODE PROMOTING CAPITAL FORMATION AND RETENTION WILL BE SWEPT AWAY. WHILE SUPPORTIVE OF REFORM EFFORTS TO CURB ABUSES IN THIS AREA, MANY IN THE SMALL BUSINESS COMMUNITY RIGHTLY FEAR THAT WE WOULD ALSO BE REMOVING A KEY SOURCES OF EQUITY FINANCING FOR SMALL FIRMS WITH SWEEPING REFORM PROPOSALS..

IN ATTEMPTING TO ALLAY THESE FEARS, I PROPOSE GREATER RELIANCE ON DIRECT EXPENSING AS A FINANCING TOOL THAN IS SUGGESTED IN THE PRESIDENT'S PROPOSAL. THE FIELD HEARINGS I CHAIRED EARLIER THIS YEAR POINTED OUT THAT DIRECT EXPENSING IS AN OFTEN USED TAX TOOL BY MANY SMALL FIRMS. INDEED, THE WITNESSES WERE NEARLY UNANIMOUS IN VIEWING DIRECT EXPENSING AS NECESSARY TO SMALL BUSINESS. DIRECT EXPENSING IS CRUCIAL TO MANY REINVESTMENT DECISIONS OF SMALL FIRMS AND IS PARTICULARLY IMPORTANT TO CAPTIAL INTENSIVE INDUSTRIES, SUCH AS MANUFACTURERS, A POINT WHICH TAKES ON ADDED SIGNIFICANCE GIVEN OUR PRESENT TRADE SITUATION.

THE PRESIDENT PROPOSES CAPPING THE DOLLAR LIMITATION ON THE AMOUNT THAT MAY BE EXPENSED AT $5,000. THIS FIGURE IS SIMPLY TOO LOW TO PROVIDE MUCH OF AN INCENTIVE TO SMALL BUSINESS. INDEED, SUCH A CAP WILL GREATLY REDUCE THE VALUE OF DIRECT EXPENSING AS THE EFFECTS OF INFLATION ARE FELT OVER TIME. THEREFORE, MY LEGISLATION PROPOSES GRADUALLY INCREASING THE AMOUNT ALLOWED TO BE EXPENSED TO A CAP OF $12,500 FOR 1991 AND THEREAFTER. THE

WITNESSES AT OUR FIELD HEARINGS CONCURRED THAT SUCH AN INCREASE WOULD PROVIDE A SIGNIFICANT INCENTIVE FOR INVESTMENT ACTIVITY, THEREBY MAINTAINING GROWTH IN OUR SMALL BUSINESS COMMUNITY.

TAX SIMPLIFICATION IS ANOTHER ARGUMENT IN SUPPORT OF INCREASING THE USE OF DIRECT EXPENSING. ACCORDING TO THE PRESIDENT'S PROPOSAL, "A LIMITED EXPENSING ELECTION, DOES, HOWEVER, HAVE CERTAIN SIMPLIFICATION ADVANTAGES. FOR SMALLER BUSINESSES, EXPENSING ELIMINATES OR REDUCES THE RECORDKEEPING AND COMPUTATIONAL BURDENS OF RECOVERING AN ASSET'S COST OVER A NUMBER OF YEARS." ACCEPTING THE PRESIDENT'S DE MINIMIS ALTERNATIVE TO MORE COMPLICATED DEPRECIATION RULES, WE SHOULD EXTEND SUCH SIMPLIFICATION TO AS MANY SMALL BUSINESS AS IS PRACTICAL.

ANOTHER ASPECT OF THE PRESIDENT'S PROPOSAL WHICH IS OPEN TO GREATER SIMPLIFICATION IS THE AREA OF ACCOUNTING. WITHOUT GOING INTO GREAT DETAIL, LET ME POINT OUT THAT WE CAN IMPROVE ON THE PRESIDENT'S PROPOSALS REGARDING CASH ACCOUNTING. UNDER THE PRESIDENT'S PROPOSAL, CASH ACCOUNTING IS ONLY AVAILABLE FOR FIRMS WITH ANNUAL GROSS RECEIPTS OF $5 MILLION OR LESS WHERE NO OTHER METHOD OF ACCOUNTING HAS BEEN USED. BASED ON CONVERSATIONS WITH SMALL BUSINESS OWNERS AND TAX EXPERTS, IT SEEMS CLEAR TO ME THAT THESE LIMITATIONS WILL EFFECTIVELY DENY CASH ACCOUNTING TO NEARLY ALL SMALL BUSINESSES.

YET, THESE SAME INDIVIDUALS CORRECTLY POINT OUT THAT ACCOUNTING RULES ARE A MAJOR AREA OF COMPLEXITY FOR MANY SMALL FIRMS. I HAVE A PROPOSAL WHICH ALLOWS FOR CASH ACCOUNTING WHERE THERE IS AN INDIVIDUAL WHO IS A SUBSTANTIAL OWNER OF THE SMALL BUSINESS AND IS ACTIVELY INVOLVED IN THE OPERATIONS OF THE BUSINESS AND, FINALLY, WHERE THE ANNUAL GROSS RECEIPTS OF THE SMALL BUSINESS ARE $2 MILLION OR LESS.

I BELIEVE SUCH A PROPOSAL CAPTURES THE SPIRIT OF SIMPLIFICATION EMBODIED IN OTHER AREAS OF THE PRESIDENT'S PACKAGE. I SEE THIS PROPOSAL AS PERHAPS A MORE MEANINGFUL DE MINIMIS RULE AND SUGGEST ITS CONSIDERATION.

IN THE AREA OF CAPITAL GAINS, I BELIEVE MOST SMALL FIRMS ARE GNERALLY SATISFIED WITH THE PROVISIONS IN THE PRESIDENT'S PROPOSAL. MY LEGISLATIVE PACKAGE RECOMMENDED A TWO-TIERED CAPITAL GAINS SYSTEM WHICH WOULD HAVE RESULTED IN AN EFFECTIVE RATE FOR SMALL BUSINESS CAPITAL GAINS VERY NEAR THE MARK OBTAINED IN THE PRESIDENT'S PROPOSAL. I BELIEVE THIS MARK SHOULD BE RETAINED TO INSURE THAT WE RETAIN A KEY CAPITAL FORMATION TOOL. SHOULD THE COMMITTEE BEGIN TO EXPLORE OTHER MEANS OF STIMULATING ECONOMIC GROWTH IN THE CAPITAL GAINS AREA, I BELIEVE S. 1130 CONTAINS SOME INTERESTING ALTERNATIVES FOR CONSIDERATION.

THERE ARE OTHER SECTIONS OF THE PRESIDENT'S PROPOSAL WHICH CAN BE REFINED IN THE NAME OF GROWTH AND SIMPLICITY. IN ADDITION, MEMBERS OF THIS COMMITTEE MAY WISH TO GO BEYOND THE PRESIDENT'S PROPOSAL TO ACHIEVE THESE GOALS. FOR EXAMPLE, CONSIDERATION OF A TAX REFORM PACKAGE PROVIDES AN EXCELLENT OPPORTUNITY TO EXTEND COVERAGE OF THE REGULATORY FLEXIBILITY ACT TO THE INTERNAL REVENUE SERVICE.

THE GOAL OF THIS ACT IS TO INSURE THAT FEDERAL REGULATION IS IMPOSED ON SMALL BUSINESS ONLY TO THE DEGREE NECESSARY TO MEET THE STATUTORY REQUIREMENTS OF LEGISLATION. AND HAS BEEN NOTED BY BOTH FEDERAL OFFICIALS AND SMALL BUSINESS OWNERS, THE RULES WHICH HAVE THE MOST IMPACT ON SMALL BUSINESS ARE ISSUED BY THE INTERNAL REVENUE SERVICE. UNFORTUNATELY, THE IRS HAS MANAGED TO EVADE COMPLYING WITH THIS ACT IN MOST CASES. THE TAX REFORM DEBATE PRESENTS AN EXCELLENT CHANCE TO RECTIFY THIS SITUATION.

FINE-TUNING THE PRESIDENT'S PROPOSAL IN THIS WAY IS CRITICAL GIVEN THE CENTRAL ROLE OF SMALL BUSINESS IN OUR NATIONAL ECONOMY. PUT SIMPLY, SMALL BUSINESS IS THE ENGINE WHICH DRIVES OUR ECONOMY. A FEW FACTS AMPLY ILLUSTRATE THIS POINT.

THE PRESIDENT'S REPORT ON THE STATE OF SMALL BUSINESS FOR 1985 STATES THAT EMPLOYMENT IN SMALL BUSINESS DOMINATED INDUSTRIES EXPANDED BY 11.4% FROM OCTOBER, 1982 - OCTOBER, 1984,

WHILE EMPLOYMENT IN LARGE BUSINESS DOMINATED INDUSTRIES GREW BY ONLY 5.3% FOR THIS SAME TIME PERIOD.

EQUALLY SIGNIFICICANT IS THE FACT THAT THE FASTEST-GROWING SMALL BUSINESS DOMINATED INDUSTRIES SHOWED HIGHER RATES OF EMPLOYMENT GROWTH THAN THE FAST-GROWING LARGE BUSINESS DOMINATED INDUSTRIES. FOR EXAMPLE, SMALL BUSINESS DOMINATED COMPUTER AND DATA PROCESSING FIRMS GREW 32%, ROOFING AND SHEET METAL WORK FIRMS GREW 23.5% AND RESIDENTIAL BUILDING CONTRACTORS GREW 22.4%. FAST GROWING, LARGE BUSINESS DOMINATED INDUSTRIES, SUCH AS PERSONNNEL CREDIT INSTITUTIONS AND SERVICES TO BUILDINGS, GREW 10.7% AND 20.3% RESPECTIVELY.

EVEN MORE ENLIGHTENING IS THE FACT SMALL BUSINESS PRODUCES A MORE-THAN-PROPORTIONATE SHARE OF NET NEW JOBS RELATIVE TO THE SMALL BUSINESS SHARE OF TOTAL EMPLOYMENT. SMALL FIRMS WITH FEWER THAN 100 EMPLOYEES REPRESENTED 37.4% OF TOTAL EMPLOYMENT IN 1976, BUT GENERATED 52.5% OF NET EMPLOYMENT GROWTH IN THIS COUNTRY BETWEEN 1976 AND 1982. PERHAPS THE MOST STARTLING PROOF OF SMALL BUSINESS' JOB GENERATING CAPACITY WAS SEEN FROM 1980 TO 1982. DURING THAT PERIOD, SMALL BUSINESS ACCOUNTED FOR <u>ALL</u> THE NET NEW JOBS IN THE UNITED STATES. WHILE SMALL BUSINESS GENERATED 2.6 MILLION JOBS DURING THIS PERIOD, BIG BUSINESS WAS LOSING 1.6 MILLION EMPLOYEES. THE NEARLY 1 MILLION NET NEW JOBS GENERATED

DURING THAT TIME PERIOD CAN BE ATTRIBUTED TO OUR SMALL BUSINESS COMMUNITY.

THE CRITICAL IMPORTANCE OF MAINTAINING A VITAL SMALL BUSINESS SECTOR IN OUR ECONOMY IS EVEN MORE EVIDENT IN MY HOME STATE OF TENNESSEE. OF THE NEARLY 83,000 BUSINESS ESTABLISHMENTS IN TENNESSEE, ROUGHLY 79,000 EMPLOY LESS THAN 100 PERSONS. IN FACT, OVER 58,000 EMPLOY 10 OR FEWER WORKERS. IN 1982, OUR SMALL BUSINESS COMMUNITY PRODUCED ROUGHLY HALF OF TENNESSEE'S $50 BILLION IN GOODS AND SERVICES. MOREOVER, THESE SMALL FIRMS CONSTITUTE 99% OF OUR CONSTRUCTION COMPANIES, 98% OF OUR SERVICE OPERATIONS, 99% OF THE FINANCE, INSURANCE AND REAL ESTATE TRADE AND 80% OF TENNESSEE'S MANUFACTURERS.

QUITE CLEARLY, MR. CHAIRMAN, SMALL BUSINESS IS BIG BUSINESS BOTH IN TENNESSEE AND ACROSS THE COUNTRY. I AM SURE THAT THE MEN AND WOMEN WHO WILL BE TESTIFYING BEFORE YOU TODAY WILL ILLUSTRATE THE CRUCIAL ROLE OF SMALL BUSINESS BETTER THAN I. AND WHILE YOUR WITNESSES TODAY MAY ADD TO THE AREAS I HAVE DISCUSSED, I BELIEVE THEY WILL SHARE MY ASSESSMENT OF THE KEY SECTIONS OF THE PRESIDENT'S PACKAGE WHICH COULD BE FINE-TUNED TO BETTER SERVE THIS NATION'S SMALL BUSINESS COMMUNITY.

I BELIEVE THEY ALSO SHARE MY VIEW THAT SUCH STEPS WILL GO FAR TO INSURE THAT WE DON'T SNUFF OUT THE CREATIVE FLAME OF SMALL BUSINESS OWNERS AND ENTREPRENEURS IN OUR DESIRE TO REFORM THE TAX CODE. WE CAN HAVE MEANINGFUL REFORM WHILE FOSTERING CONTINUED ECONOMIC GROWTH AND SIMPLIFICATION FOR SMALL BUSINESS. I APPRECIATE YOUR ALLOWING ME TESTIFY THIS MORNING AND HOPE MY RECOMMENDATIONS WILL AID IN YOUR EFFORTS TO PRODUCE A TAX BILL WHICH IS FAIR AND EQUITABLE TO OUR SMALL BUSINESS COMMUNITY.

The CHAIRMAN. I have no questions. Steve.

Senator SYMMS. No questions, but thank you very much.

The CHAIRMAN. Max.

Senator BAUCUS. No questions, Mr. Chairman, but I think we ought to point out just how much small business is the backbone of our country. I know my State of Montana, as well as the States of Oregon, Rhode Island, and Idaho are all in the same situation. I think a lot of people are proud of what you are doing, and I certainly want to thank you.

Senator SASSER. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. No, thank you. I want to welcome our distinguished colleague here. I am sorry that I wasn't here for all of his presentation.

Senator SASSER. I am confident, Senator Chafee, that you will have an opportunity to read my extended statement in the record.

The CHAIRMAN. You say you are meeting at the White House on the budget?

Senator SASSER. Yes, we are, Mr. Chairman, at 10, if I am not mistaken. So, I am going to rush over there, and I am optimistic that there will be some good news.

The CHAIRMAN. Good. Good luck.

Senator SASSER. Thank you.

The CHAIRMAN. Next, we will take our colleague from South Dakota, Jim Abdnor. Senator, it is good to have you with us.

STATEMENT OF HON. JAMES ABDNOR, U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator ABDNOR. Thank you, Mr. Chairman and Members of the committee. First, I simply want to thank you, Mr. Chairman, for your prompt reply to my request asking for this hearing on this subject because there are so many of us right here in this room who represent Members of the Senate do find agriculture and timber and forestry and small business is the backbone of our States, and certainly they do need to be heard. All we read in the papers is from larger organizations. This does give small groups the opportunity to testify, and I am pleased to see that you have such a good turnout of witnesses who want to talk on these subjects. So, I particularly appreciate this opportunity because, like you gentlemen coming from Idaho and Oregon and Montana, all three of these particular subjects are of major importance to my State, too. Of all the components of this hearing, there is no question that agriculture in my State is by far the No. 1 industry, and it is also the strength of South Dakota's economy. It is tied directly, I can say, to the prosperity of our farmers and ranchers.

I have been so concerned about these subjects that I have been holding a series of hearings at the Joint Economic Committee on the subject of what are we going to do to revitalize rural America. It is my main concern, and we see what is happening to our farms out in those rural States like mine, and they have a direct effect on the main streets of these little towns, and I am not talking even of the kind of cities of 20,000. I am talking about towns of 500 and 1,000 people. It is a great concern, and that has to be taken into consideration at a time like this. Most all of our industries are comprised of small business. In fact, I think 91 percent of South Dakota's businesses employ less than 20 people. Now, my message to Congress and to the American public is very simple: We cannot afford to have a tax code that puts agriculture or small business at a disadvantage. If our tax systems fail to be fair to agriculture and small business, then we jeopardize the rest of our economic structure, and therefore, our society and security at the same time. Just like the rest of you, I just returned from spending the Fourth of July recess back in my State, and I would like to talk about a few of the concerns and observations I ran into with my constituents, particularly in the agricultural area.

Above all else, they told me tax reform fails to simplify our Tax Code, and in a major way it fails to serve the American public. They don't think that this new proposal is all that simple. They have been talking about tax simplification, but what they read in farm magazines and in different things, they wonder sometimes if it is going to be as simple as they have been led to believe. And I have some concerns about that, too. I think that some of the things I have read in the paper sounds like it could be very complicated for farmers and maybe more so than our current tax system.

If we adopt major changes in the agriculture and business tax rules, we have got to make certain that the transition period and the transition rules are as painless as possible. Let's not make the cure worse than the disease. The phase in of a new tax system must not be unduly complicated. Particular attention must be given to modifying the investment provisions of the Tax Code. Inhibiting productive investment could jeopardize our future, and we have got to be careful with depreciation schedules and should not make those rules complicated. Most business and agriculture leaders, I think, are very worried about the outright elimination of the investment tax credit. And the elimination of capital gains treatment of certain farm commodities, especially livestock, I think could cause tremendous and unnecessary hardship to thousands of ranchers and dairymen.

The proposal to capitalize the reproductive period costs of plants and animals is absolutely contrary to our goals of tax simplification. The redtape and the recordkeeping required by such a rule isn't worth the little benefit which might occur. In my judgment, this provision could do more harm to our livestock and timber industries in South Dakota and the United States, and this provision would force all cow-calf operations to switch from a cash basis to an accrual accounting, and that is a tremendous burden on the cow-calf men and dairymen. Next, Mr. Chairman, what I really want to talk about is I want to elaborate on my greatest concern about our current tax system, and that is abuse of tax shelters. Over the past several years, this problem has mushroomed due to a number of factors, including bracket creep caused by inflation and the ability of tax experts to exploit loopholes in the code.

Last year I began studying how these abusive tax shelters were affecting the farm sector, and I was shocked at what I uncovered. Today we have tens of thousands of nonfarmer investors in agriculture who are more interested in farming the Tax Code than they are in producing food and fiber. Now, what irks me most of all is that these so-called gentlemen farmers are competing against bona fide full-time farmers who must make a profit in order to sustain their operations and to provide for their families. These gentlemen farmers are in direct competition with bona fide farmers and ranchers. By adding to our surplus projection problems, these tax-loss farmers can continue to produce at a loss while full-time farmers must earn a profit to stay in business.

It hurts me to tell you that it looks like the gentlemen farmers are winning the game today. It just isn't fair that full-time farmers should be at a disadvantage of those who apparently aren't even in business to make a profit. Now, let me give you an example. In 1982, with farm losses exceeding $200,000 at an average farm loss of some $410,000, but they had off-farm income averaging $568,000. They shelter their nonfarm income by reporting losses on their farm operations. And you and I know that you just don't throw away $410,000. Now, much of this money is recoverable in some way or another. Otherwise, the investors wouldn't have it. And I find it curious that a strong relationship exists between the amount of nonfarm income a taxpayer earns and the amount of farm losses reported by a taxpayer. The more these tax-shelter farmers make off the farm, the more they lose on the farm.

Now, let me say that again. The more these tax-shelter farmers make off away from the farm, the more they lose on the farm. On the whole, farmers reporting losses earn twice as much in nonfarm income as do farms reporting profits. Last March I had the honor to be the leadoff witness of the Senate's Agriculture Committee oversight hearing leading to the 1985 farm bill. I know I don't need to remind the members of this committee of the persistent economic hardships facing agriculture in rural America. Agriculture is in the throes of recession for the fifth straight year. The causes of these hardships are many, but not a minor cause in my judgment is the contribution these gentlemen farmers make to the cost price squeeze in agriculture.

They depress farm prices by adding the commodity surpluses, and their demands for farm inputs unnecessarily raise production costs. To add insult to injury, these so-called farmers are eligible for all Government farm programs, including income support payments. As this committee is aware, I have introduced legislation which would limit the amount of nonfarm income which could be sheltered with farm losses. I sincerely don't believe that the Tax Code should allow wealthy Americans to avoid paying taxes. My bill would limit the amount of nonfarm income which could be sheltered with farm losses to the national household median income, or about $24,600. I think that is reasonable and fair to everyone and shouldn't discourage investment in farming. If they really want to farm, if that is their intent, they can lose up to $24,600 under this proposal and take it for a loss.

If they are losing much more than that, I think maybe they had better look over their business and maybe get out of it. My legislation would recover about $2.6 billion of revenue over 3 years, and I needn't remind this panel of the deficit problem that must be addressed. My intention isn't to put the farm sector under the microscope by exposing these tax abuses. I just want to do everything I can to keep the rules fair in agriculture so that the midsized full-time family farms are able to compete against those who enjoy tax-favored status. I commend the administration for its attempt to reduce tax shelters in agriculture. We are in complete agreement that these tax shelters hurt bona fide farmers and ranchers. However, I am quite concerned that the means by which the administration has chosen to reduce these shelters will impact adversely many full-time farmers and ranchers. The goal is to separate the wheat from the chaff. Let's not turn the fan on so high that a good portion of the wheat is discarded, too. I am convinced that my approach to limiting tax shelters in agriculture is much cleaner and a more efficient approach. My bill is simple. It strikes at the heart of the problem without adversely affecting significant numbers of people we are trying to help—American farmers and ranchers. I admit that my bill may not be perfect, but it is the best remedy that has been proposed. I welcome the opportunity to work with this committee on any suggestions it may have, and I urge the inclusion of my bill in any tax reform package. As this panel deliberates this important issue, my hope is that you will keep in mind the following. Our Tax Code must be simple and fair. It must foster and promote our free enterprise system. It must eliminate abusive tax shelters and loopholes. It must detect and punish legal evasion. The American public has everything to gain from a tax reform package that meets these goals. It is up to the panel and the rest of the Congress to make sure that any tax reform package meets these challenges. Toward that end, I just want to say I appreciate this early opportunity to bring a few of the concerns of our Nation's ranchers and farmers and agriculture community to the forefront. I thank this committee for this opportunity, and I certainly appreciate your efforts to come up with a workable tax reform package, and I offer my services in any way I can. I would like to ask unanimous consent that a couple of charts also be included.

The CHAIRMAN. Without objection, they and the entire statement will be in the record. I have no questions, but let me compliment you on the perpetual and usually successful battles you undertake on behalf of farmers and especially small farmers. There is no better spokesperson for their position in the U.S. Senate.

Senator ABDNOR. I thank you.

[The prepared written statement of Senator Abdnor follows:]

SENATOR JAMES ABDNOR
STATEMENT BEFORE
THE COMMITTEE ON FINANCE
U.S. SENATE
WEDNESDAY, JULY 10, 1985

Mr. Chairman and distinguished members of the committee: it is an honor to have this opportunity to appear before you to share my views on a subject of serious importance to me, my State of South Dakota and the whole nation.

The focus of today's hearing -- the impact of tax reform on agriculture, forestry and small business -- describes major components of the South Dakota economy. Agriculture is our number one industry and almost all of our industries are comprised of small businesses. In fact, about 91 percent of South Dakota's businesses employ less than 20 persons.

My message to the Congress and the American public is very simple: we cannot afford to have a tax code that puts small business or agriculture at a disadvantage.

American agriculture throughout history has revolutionized the economy and has freed up labor and natural resources to diversify our economy in all directions imaginable. Innovation in farming has made it possible for the U.S. to become the greatest economic and military power on earth.

And the American dream has been realized by millions of individuals through small business opportunity. Free enterprise and individual initiative have proven to be unrivaled and unmatched in their ability to serve the needs and desires of society. Small business creates and fosters healthy competition in our free market system, and no market structure or political system can ever deliver more to society. Just look around the globe today: where free enterprise is given a chance to blossom, that society is prospering and growing.

If our tax system fails to be fair to agriculture and small business, we jeopardize the rest of our economic structure and therefore our society and security at the same time.

Having just returned from spending the July 4th recess in my home state, I wish to share with the committee some of the concerns and observations of my constituents. In summary they are the following:

1) Above all else, if tax reform fails to simplify our tax code in a major way, it fails to serve the American public.

2) If we adopt major changes in business tax rules, make certain that the transition period and transition rules are as painless as possible. Let's not make the cure worse than the disease. The phase-in of a new tax system must not be unduly complicated.

3) Particular attention must be given to modifying the investment provisions of the tax code. Inhibiting productive investment could jeopardize our future. We must be careful with depreciation schedules and should not make those rules complicated. Most business leaders are very wary of the outright elimination of investment tax credits.

4) Capital gains treatment on certain farm commodities such as livestock must be considered carefully. In my estimation the President's plan to eliminate it would cause tremendous and unnecessary hardship on thousands of farmers and ranchers and literally millions of consumers.

5) The proposal to capitalize the preproductive period costs of plants and animals is contrary to our goals of tax simplification. The red tape and record keeping required by such a rule isn't worth the little benefit that might occur. In my judgment this provision would do great harm to our livestock and timber industries in South Dakota and the U.S.

6) We must be positive that tax reform results in an equitable distribution of the tax burden.

Next, Mr. Chairman, I wish to elaborate on my greatest concern about our current tax system -- abusive tax sheltering. Over the past several years this problem has mushroomed due to a number of factors including "bracket creep" caused by inflation and the ability of tax experts to exploit loopholes in the code. Last year, I began studying how these abusive tax shelters were affecting the farm sector, and I was shocked at what was uncovered. Today we have tens of thousands of non-farmer investors in agriculture who are more interested in farming the tax code than they are in producing farm commodities.

What irks me most of all is that these so-called "gentleman farmers" are competing against bona fide, full time farmers who must make a profit in order to sustain their operations and to provide for their families. And it hurts me to tell you that it looks like the "gentleman farmers" are winning the game today. It just isn't fair that full-time farmers should be at a disadvantage of those who apparently aren't even in business to make a profit.

Let me give you an example. In 1982, tax returns with farm losses exceeding $200,000 had an average farm loss of some $410,000. But they had <u>off-farm income averaging $568,000</u>! They shelter their off-farm income by reporting losses on their farm operations. You and I know that you just don't throw away $410,000. Much of this money is recoverable some way or another, otherwise the investor wouldn't have done it.

I find it curious that a strong relationship exists between the amount of off-farm income and the amount of reported farm losses. The more you make off the farm, the more you lose on the farm. On the whole, farms reporting losses earn twice as much in off-farm income as do farms reporting profits.

Last March, I had the honor to be the leadoff witness of the Senate Agriculture Committee's oversight hearings leading to the 1985 farm bill. I know I don't need to remind members of this committee of the persistent economic hardships facing agriculture and rural America. Agriculture is in the throes of recession for the fifth straight year.

The causes of these hardships are many. But not a minor cause, in my judgment, is the contribution these "gentleman farmers" make to the cost-price squeeze in agriculture. They depress farm prices by adding to commodity surpluses and their demands for farm inputs unnecessarily raise production costs. To add insult to injury, these so-called farmers are eligible for all government farm programs, including income support payments.

As this committee is aware, I have introduced legislation which would limit the amount of farm losses which could be deducted against other income sources. I sincerely don't believe that the tax code should allow wealthy Americans to avoid paying taxes. My bill would limit these farm loss deductions to the national household median income, or about $24,600. That should be reasonable and fair to everyone and shouldn't discourage investment in farming.

I was astounded to learn that my legislation would recover about $2.6 billion of revenue over three years, and I needn't remind this panel of the deficit problem that must be addressed. This revenue could make a contribution to reducing it.

My intention isn't to put the farm sector under the microscope by this expose of tax abuses. By comparison to the abuses occurring in other industries, agriculture is a drop in the bucket. Only three percent of the tax shelters under investigation by the Internal Revenue Service are farm operations. I just want to do everything I can to keep the rules fair in agriculture so that mid-sized, full-time family farms are able to compete against those who enjoy tax-favored status.

I am convinced that if the effects of the tax code on other industries were analyzed to the degree that I have examined agriculture, then we truly could construct a better and fairer tax system, and I urge this distinguished panel to look into these issues deeply. I for one cannot and will not support a tax reform effort which only singles out agriculture. Agriculture is not the only industry infested by tax-dodging parasites. Again, I stress that the tax code should be fostering free enterprise, not inhibiting it.

Are small businesses in other industries facing the same circumstances as my farmers are -- tax-advantaged and leveraged schemes, contradictory federal policies, the presence of investors with large sums of income to shelter, and the like? I don't know, and I am concerned that others do not have the answer, either. But in the coming months, we must succeed in improving our tax code. Our taxpaying citizens not only demand it, but they deserve it as well.

As this honorable panel deliberates this important issue, it is my hope that you will keep in mind the following: our tax code must be simple and fair, must foster and promote our free enterprise system, must encourage growth, must eliminate abusive tax shelters and loopholes, and must detect and punish illegal evasion. The American public has everything to gain from tax reform and nothing to lose. An efficient and better tax system improves our chances for a prosperous and growing economy. And without growth, we cannot enhance our standard of living and quality of life.

I commend this committee for its commitment to tax reform and I volunteer to do my part in achieving our goals. Thank you.

Congress of the United States
JOINT ECONOMIC COMMITTEE
MEMORANDUM

AS FARM INCOME DECREASES, OFF-FARM INCOME INCREASES:

FARMS REPORTING LOSSES BY SIZE OF ANNUAL SALES

	Farm Income	Off-farm Income
Less than $25,000:	-$ 8,184	$30,288
$25,000 - 100,000:	- 28,829	31,618
Over $100,000:	- 49,459	47,426
ALL FARMS REPORTING PROFIT:	+$ 8,591	$16,284
ALL FARMS REPORTING LOSSES:	- 10,626	32,092

Source: Treasury Department, 1982 Data
Farm Proprietorships

Congress of the United States
JOINT ECONOMIC COMMITTEE
MEMORANDUM

AGRICULTURE'S "BIG LOSERS"

FARMS REPORTING LOSSES
WITH
ANNUAL SALES EXCEEDING $100,000

	ALL FARMS	FIELD CROPS	BEEF CATTLE	DAIRY	FRUITS & VEGETABLES
Number of Farms	108,559	41,444	30,010	15,777	5,551
Percent	4.0	3.4	4.1	8.8	3.9
Value of Product (Billion)	$27.811	$9.378	$9.390	$3.803	1.795
Percent	28.7	24.1	39.4	27.4	30.0
Average per Farm	$256,188	$226,276	$312,911	$241,032	$323,405
Farm Income (Average per Farm)	-$49,459	-$54,482	-$57,556	-$30,777	-$69,674
Off-Farm Income (Average per Farm)	+$47,426	+$40,702	+$69,220	+$24,334	+$65,783

Source: Treasury Department, 1982 Data,
Farm Proprietorships

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. No questions. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Mr. Chairman, I just want to say that there is no Senator in the U.S. Senate who works harder on these farm programs than Senator Abdnor does. It has been my privilege to be out there in South Dakota with him and see him tour and meet with his constituents. He is constantly working on this agricultural, small business, the rancher, and the timber problem, and I want to congratulate him. He has, as you know, Mr. Chairman, submitted legislation on this, which he has referred to in his statement, and I think it behooves us to take a good look at that legislation because he has put a lot of time and thought and energy into it. I want to join in congratulating you, Senator.

Senator ABDNOR. Thank you, Senator Chafee. Agriculture and small business is everything I have to represent, and I am extremely concerned about them. And I appreciate those kind words.

The CHAIRMAN. Thank you. Next, we will move to a panel of small business, consisting of John Motley, Brad Roller, and James Goldberg. While the witnesses are assembling, let me indicate that while we do not time the Senators' appearances, we do of the other witnesses. You are familiar with our 5-minute rule. Your statements will be in the record in their entirety. Please abbreviate your oral remarks to 5 minutes so that we will have ample time for questions. Unless you have any objections or have worked out a different order, we will take you in the order that you appear on the witness list. Is that all right?

Mr. MOTLEY. That is fine with me, sir.

The CHAIRMAN. Mr. Motley, go right ahead.

STATEMENT OF JOHN J. MOTLEY III, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. MOTLEY. Thank you, Senator. Mr. Chairman, first of all, I would like to thank you for the opportunity to appear here on behalf of NFIB and its 550,000-plus members coast to coast, and thank the committee for scheduling these hearings which deal with small business and the impact of the tax proposal on small business today. I do think that you need to pay particular attention to the overall impact of this proposal on smaller firms because I think it is fairly commonly understood today that small business is the most vibrant and the most important sector in the economy. Just a few random statistics. Just last year in 1984, we had a record number of business startups in this country, over 625,000 new incorporations, and that does not include any of the unincorporated businesses that started. Between 1980 and 1982, in the small business sector, those firms with 1 to 20 employees had a net gain of 233 percent in employment, while those firms with 500 or more employees were actually losing employment. NFIB has endorsed the President's tax reform proposal in concept because we believe that small business, in general, supports it. We recognize the extremely important role that this committee has to play in fine tuning this proposal, and we are very, very anxious to work with you to shape it over the upcoming months. The key to small business support for the proposal, we believe, is the cuts in individual and corporate marginal rates which are in it. NFIB surveys in 1981 and in 1984 indicated that, by margins of 2 to 1, rate cuts were the most important tax concern of small business. In addition to the rate cuts, there are many other important positive proposals. Just to mention one—the indexation of FIFO—but there are also concerns. We do have concerns about certain parts of the proposal. Let me briefly highlight five of them, if I may, for the committee. First of all, we are terribly concerned about effective dates and transition rules. It took the Treasury over 1 year to put this proposal together. It is going to take Congress almost 1 year to hold hearings on it. Small business community accountants and lawyers are going to have to react to it. Therefore, we are very concerned that the job be done properly so that we are not back here with another auto log situation or imputed interest situation at some time in the future. We would suggest an effective date of at least January 1, 1987, for the committee if the bill passes any time early in 1986. The second concern is what is happening in corporate rates, and it was brought up by Senator Sasser. Large corporations are given a full one-third cut at the top to supplement for the loss of ITC and the changes in depreciation. Small firms also are losing ITC and are also losing with the changes in depreciation, and there are no changes in the bottom two rates. In order to be symmetrical, you have to drop the bottom corporate rate for firms under $25,000 to around 10 percent. That does concern us, and we would ask you to address that question and possibly to find some ways to make that up for small business in your deliberations. Third, eliminating the deductibility of interest expense to $5,000. We do have some concerns that an awful lot of investors borrow personally to invest in smaller firms, and we would hate to see this provision put a dampening effect upon the activity. We would suggest that the committee take a look at the difference between borrowing for personal purposes and borrowing for the investment in smaller firms and possibly differentiate between those. Fourth, limiting the ability of certain small firms to use the cash method of accounting bothers us tremendously. Accrual accounting is much more difficult and requires generally the services of professionals, and it is also more costly to small firms. And, last, we are concerned about the continued discrimination that appears in this proposal, as in present law, between the treatment of fringe benefits taxation between incorporated and unincorporated businesses. This is particularly true, the way the code treats the deductibility of the cost of health insurance between those employees of a corporation—particularly the owner—and the owner of an unincorporated business. We can have the exact same business and, if I am unincorporated, I do not get to deduct half of the cost of my health insurance benefits for myself and my family, whereas the head of a corporation does. Senator Grassley, I believe, has—among other Senators—legislation in to deal with this.

In the spirit of one of the goals of the proposal—simplification—NFIB would like to make several suggestions. First of all, a tremendous simplification for small business—one authored by Senator Baucus and Senator Armstrong and passed by the Senate in

1983—is allowing small firms under a certain level—either dollar-wise—$5,000 or $7,500, or number of employees, 20 to 25– to deposit their FICA taxes monthly, instead of on a biweekly basis. This causes tremendous, positive effects for cash flow for a small firm, and it also reduces the amount of paperwork that they have to deal with. A second simplification that we would like to have the committee take a look at is expensing of assests. If CCRS is the economic equivalent of expensing, then why not simply look at expensing as an alternative for smaller firms? The third one is cash accounting for smaller business. The indexation of FIFO——

The CHAIRMAN. I am going to have to ask you to conclude, Mr. Motley. We are holding our witnesses to 5 minutes.

Mr. MOTLEY. Certainly, Mr. Chairman. In conclusion, let me say that over on the House side, the ranking minority member of that committee asks a question, which he calls the litmous test. If you had to choose between the present code and the President's proposal—even with all of its warts—which would you choose? For NFIB and for our members, all of the evidence so far says that we would choose the President's proposal and we would hope that the committee would work with us to help to make it even better for small business. Thank you.

The CHAIRMAN. Thank you, sir. Mr. Roller.

[The prepared written statement of Mr. Motley follows:]

STATEMENT OF

JOHN J. MOTLEY III
DIRECTOR OF FEDERAL LEGISLATION

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	Senate Finance Committee
Subject:	The President's Tax Reform Proposals
Date:	July 10, 1985

My name is John J. Motley III, and I am the Director of Federal Legislation for the National Federation of Independent Business (NFIB). On behalf of the more than half million members of NFIB, I am pleased to be appearing before you today on the subject of the President's tax reform proposal and its impact on small business.

Of all the ways in which our system of government affects Americans, our tax laws provide the most constant and direct point of contact between an individual and the government. Whether the point of contact is a weekly pay check which details federal tax withholdings or the quarterly payments made by the owner of a small business, attitudes as to fairness of our entire system of government are based on the perceptions of fairness resulting from dealing with tax rules.

Unfortunately, our tax system has changed from the fair and equitable system which led to our enviable rates of compliance to a complex and burdensome system which is turning law-abiding citizens into tax evaders. A combination of high tax rates and a list of tax benefits for wealthy individuals has destroyed the belief of many Americans in the fairness of our tax system.

It should be no surprise, then, that tax reform is a major priority for small business owners, and the members of NFIB applaud this committee for beginning the process of examining the issue of tax reform.

Small business is considered to be a prime beneficiary of the proposal efforts toward tax reform and tax simplification. It is useful to illustrate just how important small business as a sector of our economy has become in terms of providing jobs and economic growth. The following data was recently included in the State of Small Business Report to the President for 1985:

PERCENT CHANGE IN EMPLOYMENT BY
SIZE OF EMPLOYMENT, 1980-1982

Employment Size of Firm				
1-19	20-99	under 100	100-499	500 +
232.6%	-9.8%	222.8%	-31.4%	-91.4%

Additional data point out clearly that the growth in employment resulted from an incredible rate of growth in the number of firms with twenty employees or fewer. Just as clearly, the report reveals that in the same time period the large capital intensive industries were laying off people and relying on tax incentives to make themselves competitive.

Small businesses are typically in the wholesale, retail, and service trades, in addition to manufacturing. It is important for Congress to understand how the benefits of a tax code revision which reduces tax subsidies to capital-intensive firms would be put to use by labor and inventory-intensive firms. Congress should also begin to consider what the billions of dollars of tax incentives provided towards capital-intensive firms have produced.

Careful consideration of the implications tax reform has for our economy requires this committee to review the economic data of the last several years to realize where the real growth in the economy has occurred. If indeed economic growth, jobs, and entrepreneurship are to be encouraged as positive goals, the shape of tax reform legislation should reflect that reality, and the needs of those businesses should be dealt with in a positive fashion.

NFIB applauds the President for introduction of his package of tax reform proposals. NFIB supports the goals of tax reform as embodied in the President's proposal, and we support the concepts embodied in the package. The goals of economic growth, fairness,

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and simplicity are certainly the goals of the small business community. The President's package proposes to reverse the bias in our tax system which rewards uneconomic investments with tax incentives and promotes complexity over simplicity. The owners of small businesses have borne the brunt of this unfair and complex tax system for too long, and they have been frustrated by the loss of earnings and the hidden costs expended to comply with these rules.

Small business needs Congress to move forward carefully and considerately on tax reform legislation. These reforms are critical if the small business sector is to be expected to continue providing this country with new jobs and new opportunities.

While timing is a concern for political and economic reasons, we are more concerned at this point that the staffs have adequate time for drafting and that the members have adequate time for debate, to ensure good legislation.

Overlegislation

As this committee begins consideration of major overhaul of the tax system, it should consider the impact other recent pieces of tax legislation have had on small businesses and individuals. Since 1978, Congress has enacted four major pieces of tax legislation. Not including the minor pieces of legislation this committee has enacted, these four major tax bills have resulted in over 2,600 additions, deletions, and changes to the Internal Revenue Code. In addition to these code changes, thousands of pages of new regulations, numerous revenue procedures, and revenue rulings have been published as well. A major growth industry has been developed by the reporting services that report and compile the changes to the tax laws.

This deluge of changes and rules must be stopped. Small business owners and individuals are placed at a severe disadvantage relative to the large business or wealthy individual with the financial resources to retain a full time tax counsel. For a business owner, the ability to plan is a key component of economic growth. In the last six years, planning was sacrificed, and the inconsistency which resulted was caused by the many tax bill changes. For Congress to place a small business owner in a position of having to choose between high taxes or high accountant bills is inconsistent with basic tax policy principles of fairness.

Effective Dates

Implementation of a tax reform package as broad as that which is being discussed will bring into focus the issue of effective dates. This issue is of concern for small business for, while we welcome the possibility that Congress might enact tax reform by the end of the year, imagine the panic that would occur among the owners of small businesses if the new rules were to become effective immediately. Overnight they might be required to understand and implement tax rules which may be substantially different from current law.

A major consideration in establishing effective dates will be revenue gained or lost. This committee should also be concerned that sufficient time is allowed for taxpayers to adjust to and understand how the new tax rules affect their businesses. In addition the IRS should be given sufficient lead time to revise regulations and tax forms so the taxpayer will not be operating in the dark when his tax bill comes due.

For any tax reform package to be considered truly successful, it must be simple or it will not be fair. If the reforms result in higher compliance costs, the result will be a waste of resources which would otherwise be leveraged by the small business to foster economic growth and new jobs.

Economic Growth

Our current tax system impedes economic growth by rewarding uneconomic choices and subsidizing capital-intensive industries at the expense of inventory-and labor-intensive industries. Over the last five years, there has been economic growth in various sectors of our economy; small business has done its share. However, recent data would appear to indicate that the economy has reached a growth plateau. A plateau can either be a resting point or a peak. The current plateau will be a peak unless Congress takes positive action to change a tax system which channels tax benefits to a few into a tax system which rewards hard work and encourages new investments and jobs.

Economic growth must be a goal of tax reform. Growth can best be accomplished by taking tax considerations out of the business decisionmaking process. What should result is a tax system which attempts to level tax incentives so one sector of society is not subsidizing another sector of society.

We would encourage this committee to review the economic data of the last five years and see which sector of the economy has generated economic growth and new jobs. Given the resources required, and given the proper incentives for capital formation and growth, the small business sector(s) of our economy will provide the backdrop for an enormous increase in productivity and technology, leading to new markets and opportunities.

SMALL BUSINESS GOALS IN TAX REFORM

It is our intention to comment on specific aspects of the President's proposal that affect small business, evaluated by the three criteria the President has outlined: simplification, economic growth, and fairness.

Simplicity vs. Complexity--The Hidden Tax

Tax compliance costs under today's tax system amount to a hidden tax on small business. Compliance costs require a small business owner to devote limited financial resources to file and maintain an ever-increasing amount of paper and records. Complex tax rules and excessive information requests often are a greater burden than a direct tax assessment. The depth of feeling on this issue should not be misjudged, as the recent episode with the regulations on automobile recordkeeping revealed to us all.

The last word in the title of the President's proposal is simplicity. Yet simplicity is the one area where the President's proposal is not as strong; it appears that simplicity has sometimes been sacrificed for fairness. For small business, however, simplicity is the key point of tax reform and a point which we hope this committee will be cognizant of in its deliberations.

The overriding concern of small business for simplicity in tax rules is best illustrated by surveys which NFIB sponsored several years ago. The surveys reveal that a full 25% of small business owners prepared their own taxes without benefit of an attorney or an accountant. It is highly unlikely that the nuances of cash vs. accrual accounting or indexing would be understood by these business owners.

Reduction in Marginal Tax Rates

Two goals of tax reform are fairness and economic growth. In the minds of many owners of small businesses, especially non-corporate small businesses, these goals are achieved by reductions in marginal tax rates. For the millions of small businesses operated as sole proprietorships or partnerships, there is only one way to achieve any tax relief, i.e. rate reductions. The bulk of non-corporate small businesses tend to be service or retail establishments. For them, the issues of depreciation and capital gains are not important. Nor can reform for these types of businesses be framed in terms of equity financing or accounting methods. The only type of tax reform which helps these small businesses is tax rate reductions, because reductions promote capital retention.

All too often tax policy planners assume that small business owners view their business profits as disposable income. It was never considered that these small business owners might actually be business planners as well as consumers. Our research reveals that the bulk of growth of small businesses is financed not from equity capital, but from internally-generated earnings.

This point is further illustrated by NFIB's Quarterly Economic Report, which surveys NFIB members on their current economic situation. Over the last year, the QER has consistently showed increased levels of investment in capital equipment and inventories by NFIB members. Over this same time period, the frequency of borrowings declined. This means that an increasing amount of investment and growth by small businesses is being generated by earnings growth, the least expensive kind of capital formation policy because it treats all individuals the same.

Reductions in marginal tax rates are therefore critical to small business, and there is significant support for a reduction in the number of tax brackets for individuals. Limiting the number of tax brackets gives the perception of equality as well as tax relief.

Graduated Corporate Tax Rates

The tax reduction act of 1975 effected a graduated tax schedule for small corporations, taxing the first $25,000 of taxable income at 20%, the next $25,000 at 22%, and all taxable income in excess of $50,000 at 48%. The graduation schedule, enacted temporarily in 1975, was made permanent in the Revenue Act of 1978, with some additional changes that graduated the first $100,000 of corporate taxable income.

The Revenue Act of 1980 was amended by the Economic Recovery Tax Act of 1981, taxing the first $25,000 of taxable income at a 15% rate, the next $25,000 at 18%, the next $25,000 at 30%, the next $25,000 at 40%, and in excess of $100,000 at 46%.

The graduated tax for small corporations continues to be among the more positive changes in tax policy, resulting in tax relief and growth among many small corporations. The graduated corporate income tax is not a tax dodge or a device for sheltering the income for wealthy professionals. In 1975, 1978, and 1981, graduation of corporate tax rates was approved and enacted by Congress for some of the following reasons:

> The bulk of tax incentives in our tax laws applies to capital-intensive firms (depreciation and investment tax credit); a corporate rate graduation applies to all firms, especially the bulk of small, inventory and labor intensive firms.
>
> A corporate rate cut reduces the bias toward debt financing.
>
> A corporate rate cut reduces the effective cost of capital and assists in attracting investment capital into small business. While depreciation and the investment tax credit accomplish the same objectives, they are only effective for capital-intensive firms.
>
> The benefits of graduation are targeted directly to small firms. Conversely a flat corporate rate would add a significant burden to small firms' tax liabilities.

(Excerpts of a report on "Tax Policy and Capital Formation," prepared by the staff of the Joint Committee on Taxation.)

Currently some 75% of all corporations fall within the class of firms benefitting from graduation by allowing them to retain earnings at a lower tax rate and to use these earnings to buy inventory, expand capacity, and hire new employees.

The President's proposal is positive for its favorable treatment of small corporations through the retention of graduated corporate tax rates. A broader view of the tax proposal reveals, however, that large corporations are receiving a large tax rate cut, from 46% to 33%, as a tradeoff for losing the benefits of the investment tax credit and accelerated depreciation. The tax status of small corporations, if they do not buy capital equipment, is left virtually the same under the President's proposal. If they buy equipment, they may experience a minor tax increase as a result of the changes in depreciation and elimination of the investment tax credit. This is not a plea for retention of current law; it is a plea for a goal of this package, i.e. fairness. It is unfair to provide such a large tax cut to large firms and no tax cut to small corporations.

It is in the context of fairness that the following concerns and issues are proposed.

Capital Formation

The President's proposal invokes a substantial shift in capital formation policies by repealing the investment tax credit and replacing the Accelerated Cost Recovery System (ACRS) with a new Capital Cost Recovery System (CCRS).

Depreciation rules prior to 1981 were one of the greatest sore points for small business owners. The old Asset Depreciation Range (ADR) rules were a nightmare for small firms. The net result of these complex rules was that small businesses were cheating themselves out of depreciation benefits by choosing the least controversial but least beneficial depreciation method, which had the effect of depreciating assets over a substantially longer period of time than large businesses were doing. These disparities were quite large in real dollar terms and were further exacerbated by the period of high inflation we were experiencing during the late seventies.

In 1981 Congress enacted ACRS, which provided small businesses with one major benefit, simplification. A taxpayer could easily determine which depreciation class the asset belonged to. Once that was determined, it was simple to follow the schedule to determine that year's cost recovery deduction. For small business simplification of depreciation rules far outweighed all other considerations, especially when paired with the increased amounts of investment tax credits.

We are therefore less concerned about the actual amount of depreciation benefits provided by either ACRS or CCRS than we are about the simplicity and practical availability of the cost recovery benefits. Having said that, we are also concerned that the cost of capital not be made excessively high so small manufacturers are put in a less competitive position than their foreign or domestic counterparts.

CCRS, the new proposal for depreciation, poses a mixture of results for small firms. It appears to be not very different in concept or application than ACRS, with one exception. Under the CCRS proposal, the basis of the assets will be indexed for inflation prior to applying the depreciation schedule. Annual indexing of the basis of assets is a concern because it complicates depreciation rules. Indexing will require additional paperwork and additional accountant's time, which costs money. Small businesses will have to keep detailed records on the cost of an asset, the depreciation of an asset, and the annual index to be applied each year.

Indexing creates an additional concern. The indexing percentages could become a convenient revenue target for Congress during debates on budget deficits. As a result we might see Congress making annual changes to the depreciation rates of assets in an attempt to balance the budget. Indexing itself is complicated enough, but the possibility of the indexing formula varying over a period of time is an additional concern.

<u>Expensing</u>

With the possibility of indexing becoming a fixture in tax policy for depreciable assets--and the complexities which this type of proposal would introduce--it may be time to consider expanding a proposal which is already in the law, i.e. expensing of assets.

Current law allows the expensing of assets up to $5,000, with the amount increasing to $10,000 in 1990. Unfortunately the President's proposal seeks to limit permanently the amount which could be expensed to $5,000.

We would propose for your consideration allowing a small business to expense up to $50,000 of an investment. We propose it as a simplification and as an economic growth incentive. We propose it in the context of it not being too costly--and we have yet to run revenue estimates on this--but if CCRS is the economic equivalent of expensing, the revenue loss should be minimal.

The benefits of this proposal, from the perspective of simplification, are obvious. Not only is the depreciation rule simplified; the recapture tax is simple because the basis of the asset for tax purposes will always be zero, and the gain is then the sales price.

<u>Capital Gains</u>

The President's package is intended to provide incentives both to small, growth-oriented small businesses and to investors to invest in small businesses. A preferential tax rate on capital gains is one way investors are attracted to new investments.

Capital gains and the rate at which they are taxed are very important issues for small businesses looking for equity financing. The preferred tax rate on the sale of capital assets provides an investor with a risk incentive to invest in a small business. The reduced tax rate gives the investor an incentive to risk capital in a small business instead of investing in a secure, publicly-traded stock. The incentive is necessary because if a small business pays off, it does so at a higher percentage than a large company. Therefore the lower tax rate is very important.

Current law provides for a maximum tax rate of 20% on the sale of capital gains. This rate might be lower depending on the individual's tax bracket. The President proposes to reduce the maximum tax rate to 17.5% on capital gains, providing a further incentive for investors to invest in small businesses. However, we believe it, is finally time for Congress to consider a bold new approach to small business financing.

While the lower capital gains tax rate provides a limited incentive to investing in small firms, it does nothing to target investments in small businesses in greatest need of investment capital. Even with the preferred tax rate, investors have tended to shy away from the riskier smaller ventures which might ultimately prove successful. The tendency is, if somone invests in a high risk venture, plenty of tax benefits must at least be available as part of the package.

As Congress may do away with the bulk of these tax motivated incentives, we are wondering if this is not the time to be considering an investment proposal which has already proved successful in another area. The ability to defer the capital gain on the sale of a principal residence if a new residence is purchased of at least equal price, has been a major reason for the increased amount of home ownership. Small business could use a similar device which allows for a deferral of capital gains taxes on the sale of an investment only if it is reinvested in a qualified small business. A stated goal of the President's package is to provide incentives for growth of new and growing small businesses to attract capital on an equal basis with big business. Well, even a level playing field has its areas of support, and we believe that this is one such area which should be investigated.

One troublesome aspect of the capital gains proposal is its complexity as it applies to depreciable assets, the machinery and equipment owned by a business. The new proposal would not allow these assets to be considered eligible for the lower capital gains rate. Instead, the basis of the asset will be indexed as it is depreciated, therefore it is proposed that the basis of the asset--being fully indexed for inflation--does not require the additional benefits of a capital gains preference. This proposal has an interesting side effect. As an investor in small business, my paper investment is eligible for capital gain treatment. However, as the owner of the business, my investment in the assets and the goodwill will be taxable as ordinary income upon liquidation or sale. This appears to put an undue burden on the owner of the business, who is an investor just as much as a third party.

Small businesses are typically the businesses that will use these rules, for how often does a large business liquidate? NFIB recommends that the issues of capital gains, indexing of capital gains, and deciding which assets qualify for capital gains receive thorough review as to their impact on small firms. We also recommend that the committee examine whether a capital gain rollover could be the type of investment vehicle which could provide significant benefit at little cost.

Limitations on Deductions of Interest

The President's proposal would limit the deduction for interest expense to $5,000 plus investment income. NFIB has a particular concern in this area. It is quite common for an investment in a small business to be made with borrowed funds. In addition debt financing might be used when an individual is buying a share of a business. The problem is that the interest expense is generated at the personal level, not by the business, and the amount of interest could cause the limitation to come into play. We are concerned that this provision could inhibit or prevent the sales or the transfers of small businesses. We believe that this is an unintended effect of this proposal, and we would like to see the language of this proposal clarified to reflect that the limits will not apply to investments in a business in which the investor is an active participant.

Dividend Deductibility

The President's proposal calls for the deductibility of 10% of the dividends of a corporation, essentially treating interest and debt alike for tax purposes. NFIB agrees that this is a proposal which could encourage equity participation in many small businesses and could be a positive factor in attracting new investments to small and growing businesses. However, 10% of the dividends paid by General Motors is quite sizable, while 10% of the dividends of a small business is virtually peanuts. We would encourage the committee to consider a proposal to allow the deductibility of the first $100,000 of dividends or 10% of dividends paid, whichever is greater. NFIB believes that allowing deductibility of dividends at some substantial level for small firms will have a beneficial impact on the ability of these firms to attract equity financing and assist in capital formation. This point is crucial since the CCRS proposal may have the effect of increasing the cost of capital to a small business.

Accounting Methods

The President's proposal recommends several changes in accounting methods. One proposal would allow for the indexation of FIFO (first in, first out) inventories; the second proposal would limit the availability of the cash method of accounting.

FIFO Indexing

Under current law an inventory-intensive business is required to use one of several methods of accounting for inventories so the tax return accurately reflects both the cost of goods sold and gross profit. The accounting method most commonly used is the FIFO method because it conforms to the stream of purchases and recognizes a basic principle of selling the oldest items in inventory first. During periods of rising prices, however, the FIFO method hurts a business. As prices rise, the value of the goods remaining in inventory increase, thereby increasing the value of ending inventory and increasing the taxable income. These inflated values result in paper profits.

The other method is the LIFO (last in first out) method for valuing inventories. This method allows inflated values of ending inventories to be eliminated so the firm does not pay taxes on inflated paper profits. However, LIFO carries with it a major drawback. It is extremely expensive to implement and requires knowledge of fairly sophisticated accounting concepts to maintain. Obviously this limits its applicability; only 40,000 corporations are able to afford the expense of implementing LIFO and the cost of the accounting expertise to maintain it.

In 1981 Congress enacted legislation to let a business use LIFO by basing the adjustment to inventory on published consumer price indices. This proposal was limited to firms with gross sales of less than $2 million. This proposal is very much like the proposal for indexing on a FIFO basis. Unfortunately, this may not be an advantage; as far as we know, very few businesses have elected this alternative within LIFO, the problem being that the implementing regulations were too complex for firms below $2 million in gross sales to use or even consider the LIFO alternative.

FIFO indexing may solve part of this problem because it does not have the onus of being called a LIFO method. However, if the implementation of the proposal is not made practical, it may suffer the same fate of rejection by small businesses because of complexity.

The issue of inventory accounting methods is an important one for many small wholesalers and retailers; they are frustrated that the rules and regulations to provide them some tax relief are so complex only large corporations can use them.

NFIB would recommend that the committee explore two options: FIFO indexing, and allowing small wholesalers and retailers to use the cash method of accounting. Allowing the cash method for small businesses that carry inventory would have a double benefit at very little cost. First, small firms would not have to use sophisticated accounting methods which require expert accounting assistance and waste financial resources. Second, cash accounting would be a real simplification of the tax rules for many small businesses receiving very little tax relief in this proposal. The revenue loss from allowing use of the cash accounting method should be roughly equivalent to the revenue loss from instituting FIFO indexing. In fact the revenue loss from each of these proposals should not be considered since the LIFO method is generally available as an alternative.

In addition, the 1981 tax bill required the Department of Treasury to study the area of accounting and inventory methods and to report to the Congress the results of this study by December 31, 1982. It would certainly be helpful if we had this document prior to making the types of changes in the tax rules we are discussing.

<u>Limits on Cash Method of Accounting</u>

The President's proposal proposes to limit the availability of the cash method of accounting to businesses if they meet both of the following criteria: gross sales do not exceed $5 million and no other method of accounting has been used regularly to determine income or profit for the purpose of reports or statements to outsiders.

NFIB is concerned that this proposal would push many small businesses into the accrual method of accounting for tax purposes, resulting in higher accounting fees and accelerated tax liabilities.

The implications of this proposal are that service businesses and other businesses carrying no inventory may be forced to go on the accrual method. Also, if a small business of any size of gross sales goes to a bank on a regular basis for loans or to establish credit lines, the business generally must provide a statement to the bank on an accrual basis. Under these circumstances the business would be forced to use accrual for tax purposes as well. This means that the business will have to recognize as taxable income the value of receivables or billings, possibly forcing these firms to borrow funds to pay tax liabilities on incomes they have as yet not received.

Corporate vs. Non-Corporate...Health Insurance for Self-Employed

One aspect of this tax reform proposal is that it may further widen disparities in treatment of corporate vs non-corporate businesses. Several examples exist in current law, the most glaring of which is the treatment of health insurance for the owner of a non-corporate business.

Under current law, the owner/employee of a corporation is treated as an employee for all tax purposes, including withholding of payroll taxes. However, he is also an employee for purposes of participation in an employee health insurance plan. Therefore the value of health insurance premiums paid by the business on his behalf is a business deduction.

For a small non-corporate business -- a farmer, a barber, or a salesman -- the same health insurance premium is not deductible as a business deduction. As a result of the 1983 social security legislation, the self-employed owner of a business is equal to the owner of a corporate business for all tax purposes except this. NFIB believes this treatment should be equalized for owners of a business, provided employees are equal participants in such coverage on a non-discriminatory basis.

Increase Spousal Individual Retirement Account Limit

The purpose of the individual retirement account (IRA) is to allow individuals to save for their retirement in before-tax dollars. Under current law an individual must have earnings to start to contribute to an IRA, plus a nominal additional amount for a non-working spouse. Typically the owner of a small business receives a substantial amount of assistance from a spouse, even if the spouse has never been officially recorded as an employee of the business. However, since the non-working spouse receives no salary, the working spouse is prevented from providing retirement savings at a level equal to a two-wage-earner family with similar amounts of income.

NFIB supports the expansion of the spousal IRA limits to insure that family units whether comprised of one wage earner or two wage earners be allowed to set aside equal amounts of savings for retirement in IRAs.

PROPOSED SIMPLIFICATIONS

Based on the premise that every proposal can be improved NFIB would like to recommend for consideration several tax simplifications that fall in with the overall purpose of the plan and do not materially impact on revenues, but which would have a very positive impact on many small businesses.

Changes in Payroll Tax Deposit Rules

Current IRS regulations provide that an employer must deposit payroll taxes within specified time frames. The timing is related to the amount of the withholdings: if the monthly withholdings are less than $3,000, the business must make monthly deposits of payroll taxes. We believe this is fair. However, this level was established in 1980 when the payroll tax rate and the base were far lower.

Under the same regulations, if total withholdings exceed $3,000 a month, the business can be required to make up to eight payroll tax deposits in a month. The level of paperwork this situation can generate, and the addition in accounting fees, can become very costly for many small businesses that do not own or use computers. In fact we estimate that under general circumstances, and varying with a firm's salary structure, the eight-payments-per-month trigger can be reached by firms with as few as 20 employees.

The impact payroll taxes have on labor-intensive small businesses cannot be overemphasized. A study of small business tax burdens in 1981 revealed that over 70% of the tax burden of a small business is typically in payroll taxes. As a result of the substantial increases in payroll taxes and the payroll tax wage base since 1983, this situation has only worsened.

As a real simplification which costs the Treasury no tax dollars, NFIB strongly recommends that the threshhold amount be increased to $7,500. Alternatively, the threshhold could be increased to $5,000 but should index the amount for increases in the payroll tax wage base. Small firms are united in their opposition to being forced to endure these paperwork burdens more frequently than monthly. In addition no firm with fewer than 25 employees should be required to make payroll tax deposits more frequently than once a month.

The burden of payroll taxes on small business continues to increase as a result of the 1983 social security legislation. Indications are that the social security trust funds, now solvent, will begin to build up surpluses ranging in the trillions of dollars over the next twenty years. This surplus may be building up in excess of actuarially--projected needs of the social security system. NFIB wonders whether this surplus buildup for the future is in our best interest if the high payroll tax burdens funding this buildup are costing jobs today. NFIB would encourage this committee to review this situation to determine if payroll tax rates could be reduced as an incentive to create new jobs.

Cash Method of Accounting

The concept of allowing small retailers and wholesalers to use the cash method of accounting bears repeating a major simplification for thousands of small businesses. It is not hard to understand why a small business would want to use the cash method of accounting. It is the accounting method with which individuals--and unsophisticated business owners--typically are familiar. Allowing small firms to use the cash method even when they have inventories would not have the feared effect of distortions in tax liability or result in unnecessary purchases of inventory to distort tax results. Small firms do not have the financial capabilities to buy more inventory than they can quickly use, due to normal turnover rates, and the net revenue effect of allowing the cash method would probably be close to FIFO indexing.

As we previously stated, it would be very helpful for this committee to request the results of the Treasury study on accounting and inventory methods which they were mandated to perform and to review the issues of accounting and inventory methods in the context of providing some positive simplifications.

Regulatory Issues

In 1980 Congress enacted the Regulatory Flexibility Act, which requires executive agencies, when issuing regulations, to determine if the regulations will result in a disproportionate impact on small business. If after analysis such an impact is determined, the agency is authorized to modify the regulation to minimize the impact on small firms. This law makes eminent sense, especially in view of how complex the tax code has become over the last fifteen years.

IRS has claimed an exemption from this law based on an interpretation of the law which clearly circumvents the specific intent of those who drafted it.

NFIB strongly recommends that as a part of tax reform the IRS be brought into the mainstream and be required to perform regulatory flexibility analyses on new regulations.

Equal Access To Justice Act

NFIB strongly recommends that the provisions of the Equal Access to Justice Act be extended to tax cases. This is an area in which the Ways and Means Oversight subcommittee has been interested. Essentially the law provides for reimbursement of attorney fees and court costs to prevailing small businesses in administrative or court cases involving federal agencies. We recognize such cases are covered under Section 7430 of TEFRA. At the least, the existing provision must be amended to conform to the EAJA provisions which govern all other agencies. There is no justification for treating tax cases any different than any other case involving a small business and a government agency.

Proposed Legislation

Legislation has been introduced by several Senators which encompass many of the issues discussed in this statement. Each of these proposals address issues of concern to small business; as such, they merit your consideration as this committee considers tax reform legislation.

Retention of graduated corporate rates has been a primary goal of NFIB in tax reform; this issue is the specific goal of Senate Concurrent Resolution 41, introduced jointly by Senator Baucus and Senator Armstrong.

Other pieces of legislation which include many of the issues I have discussed are S.419, introduced by Senator Grassley, S.1130, introduced by Senators Sasser and Grassley, and S. 1085, introduced by Senator Kasten. I understand that Senator Baucus will be introducing legislation soon to address small business concerns in several regulatory areas as they apply to the IRS.

Conclusion

The prospect of tax reform is an energizing and uniting influence on small business owners. The difficulties small businesses experience under the current tax code are serious and present severe impediments to growth and expansion. However, our desire for tax reform is closely linked to small business concerns over the federal deficit.

NFIB has long been in the forefront of business groups concerned with the growing federal deficit. Our current budget situation is sufficiently precarious that revenue estimates of the impact of every proposal must be considered for their effect in raising or lowering tax revenues. However, static revenue estimates are just that . . . estimates. They are not capable of factoring in the potential growth which may result from any given incentive.

We encourage you to concentrate on revenue effects not just in a static context, but in a dynamic context as well. Do not ignore the potential a particular provision or proposal may have as an incentive to raising capital and growth simply because of some initial revenue loss. We would also encourage you to resist the temptation to use tax reform as a tax increase platform. A revenue-neutral posture should be maintained as the tax reform proposal moyes forward.

NFIB would like to thank you for the opportunity to present our views on the President's tax reform proposal and to provide you with the unique perspective of small business on several specific aspects of the President's package.

As we stated initially, NFIB is pleased that we are finally here to discuss tax reform, and we are anxious to assist this committee in every way possible to ensure that the goals of tax reform are achieved. We offer you our full cooperation in attempting to draft a tax reform bill which achieves the goals of simplicity, economic growth, and fairness. In addition, we encourage you to avoid as much as possible frequent changes of the new tax rules you enact in tax reform so we can all learn how to plan once again.

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STATEMENT OF BRAD ROLLER, PRESIDENT, SMALL BUSINESS UNITED; AND PRESIDENT, SWIGER COIL SYSTEMS, CLEVELAND, OH

Mr. ROLLER. Thank you. Good morning, Mr. Chairman. I am Brad Roller. I am the president of Swiger Coil Systems, an electrical manufacturer in Cleveland, OH, and I am here today as the volunteer president of Small Business United, which is a coalition of 17 regional, grassroots, small business organizations that cover about 35 States. Most of our members are incorporated small businesses. I brought with me Ronald Cohen, who is the managing partner of a regional CPA firm in Cleveland which specializes in small business tax and financial matters and is a Small Business United tax volunteer. He is here to help me with any of your questions which may be beyond may expertise in the tax field. We are very grateful for this opportunity to express SBU's views on the tax reform proposal. We certainly agree that the inequities and the complexities of the Tax Code as it is now tend to undermine the voluntary assessment process that is so critical to our democracy. However, we stress one critical element. Any reform of the Tax Code must be accompanied by a commitment that there be no new major tax legislation for the next 5 years. Many of the complexities of the current system are due to the fact that the code changes on a regular basis. It certainly must be as difficult for you to run the Nation as it is for us to run our small businesses when the Tax Code changes every year and to make plans for the future. The first point I'd like to make is that the President's proposal restores two critical elements that would have been eliminated had Treasury I been adopted. And those elements are the graduated corporate rates and the retention of the capital gains deductions, although we do feel that the rates could be graduated further. With this in mind, SBU is prepared to support with some degree of enthusiasm the President's proposal. However, it would be inappropriate for us to ignore some real problems that we have and some real sacrifices that some of our members would have to make, were the proposal enacted the way it is right now. Although most small businesses are labor-intensive businesses, many of them are capital intensive, and the elimination of the ACRS and the ITC would have a negative impact. I also have serious doubts that if the new depreciation proposal represents any simplification at all. As a matter of fact, I think it is complication of the law. The elimination of IDB's would also be a problem since many of our members use IDB's for expansion of their businesses. And the limitation on business deductions and other benefits certainly is a negatively impacting idea, and I also don't feel that that has any real simplification with it. Also, the elimination of the bad debt reserve would create hardships for many of our members. However, we are willing to do our share in making sacrifices if it is going to lead to simplification of the code and the good of the Nation. And we believe that these sacrifices make our support of most of this proposal reasonable. However, one provision that we feel very strongly shouldn't be part of the tax system is prohibiting the use of cash accounting for companies with revenues exceeding $5 million or which use accrual basis numbers in any other portion of their business. Currently, only businesses that have inventory have to use the accrual method, which recognizes income when merchandise is sold or when services are performed, rather than the cash basis, when cash is received and expenses when they are paid. Probably most of the small business community is in the service industry and is entitled to use the cash basis method for accounting right now. The $5 million limitation may seem like a high number that would eliminate most small businesses from this provision; however, most well run small businesses use accrual numbers somewhere in their day-to-day operation. Either they keep track of their payables and receivables, or they have to submit accrual basis numbers to their banks for credit, and they would be severely penalized were this to be enacted. We also don't feel that this legislation addresses these small businesses' needs for capital formation adequately. With small banks, SBA loans, UDAG's, IDB's, and a couple of other capital formation vehicles looking like they are going to be history shortly, small businesses' ability to attract capital is being severely handicapped. Quite frankly, under current law, any individual with enough money to loan to a small business has probably got enough sense not to do it, the way the laws are structured right now. The up-side potential on loaning money to a small business is limited to the return of your principal plus interest, which you pay tax on; and your downside is limited—no, the downside is extended to the loss of your investment, which under current law can only be written off $3,000 a year as a capital loss. This problem could be alleviated were the investment vehicle, called the small business participating debenture, enacted; and we have submitted some information on this item. We also feel there should be a provision——

The CHAIRMAN. I have to ask you to conclude, Mr. Roller.

Mr. ROLLER. Another major concern, other than capital formation, is that the proposal to tax health care benefits—even though it is a small amount—represents a foot in the door for future taxation, were a less scrupulous Congress to decide to raise some revenue in the future, and we have some real serious concerns about that. Thank you for this opportunity.

The CHAIRMAN. Thank you, sir. Mr. Goldberg.

[The prepared written statement of Mr. Roller follows:]

TESTIMONY DELIVERED BY
BRAD ROLLER
PRESIDENT, SWIGER COIL SYSTEMS, CLEVELAND, OHIO
AND
PRESIDENT, SMALL BUSINESS UNITED
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
July 10, 1985

INTRODUCTION

Good Morning: My name is Brad Roller. I am President of Swiger Coil Systems, Inc., a small manufacturer in Cleveland, Ohio. I am appearing here today, however, as President of Small Business United. SBU is a voluntary coalition of seventeen grass roots small business organizations representing thirty-five states, over 35,000 members, and approximately three-quarters of a million employees. Nearly all our members are incorporated businesses.

I also have with me, Ronald Cohen, founder and managing partner of a regional CPA firm in Cleveland which specializes in advising small businesses on taxes and other financial matters. Ron has been an active SBU volunteer and has served as a resource person for our organization in the areas of taxation and capital formation. Ron is here to help me with any of your questions which are beyond my expertise.

We are proud and grateful to be given the opportunity to express SBU's views on the President's Tax Reform Proposal which your committee is currently considering. We are most pleased at the priority which both the President and the Congress have given the issue of tax reform. We certainly agree that the complexities and inequities in our system have tended to undermine the voluntary assessment process which is critical to our economic well being. We stress, however, that any real reform must be accompanied by a commitment to avoid any new tax legislation for at least five years. Many of the current complexities are due to the continual changes.

SBU SUPPORT

The first specific point I want to make is that the President's recommendation restores two critical elements of the current law, which would have been eliminated had the provisions of Treasury I been adopted. I am referring to the graduated corporate tax rates and the capital gains deductions. The President correctly recognized the importance of maintaining the ability of small companies to attract and retain capital.

Small Business United is prepared to support this legislation with some degree of enthusiasm because we feel that the nation, as a whole, will benefit from real reform. However, it would be inappropriate to ignore some real sacrifices which many of our members will suffer if this legislation is enacted. Although small businesses are labor intensive, many are capital intensive. The elimination of ACRS and the Investment Tax Credit would certainly have a negative impact on these members. Furthermore, the small business community has used Industrial Development Bonds for expansion, and would sorely miss this very important capital formation tool. Limitations on travel, entertainment, pension plans, and other employee incentives and executive perks will impact very strongly on some of our members. The elimination of the bad debt reserve would likewise create hardships. Nevertheless, we are certainly willing to do our share in helping reduce the rates and making our taxes fairer. We believe the above sacrifices are reasonable ones for us to support.

CASH BASIS SHOULD BE RETAINED

One of the major problems of the President's Proposal, as it pertains to small business, is the treatment of companies currently reporting on the cash basis method of accounting. The Proposal would call for all companies deriving $5 million or more in gross revenues over an average of a three-year period to use the accrual basis method of accounting. In addition, any company which reports any accrual basis information to its shareholders, or regularly prepares accrual basis financial statements, or uses accrual basis information in obtaining credit, would also be covered by the provision.

It is possible that some organizations, in which inventory is not an income-determining factor, may unfairly be taking advantage of a system which allows businesses to use the cash basis method of accounting. These companies can adjust their income from year to year by accelerating or deferring receipts and/or disbursements. Whereas it would be equitable to adopt a provision which might eliminate any such potential abuse, the enactment of such a law, in our opinion, would be throwing out the baby with the bath water. The majority of businesses using the cash basis method of accounting are accurately reflecting their income because their actual income depends on their cash flow and nothing else. Most of these companies are in labor intensive, service businesses where most of their expenses (payroll, rent, benefits, etc.) must be paid on a current and regular basis. Their income, both billed and unbilled, is not received until a much later date and often in an amount negotiated downward from the original price.

The problems which would be encountered by many companies could prove fatal to those entities. Whereas a service business might have receivables on their books representing from two to six months billings, that amount could be a substantial multiple of annual profit. A typical service business, such as a CPA firm, doing $3 million in annual fees might have annual profits available to the partners of $600,000 to $800,000. But, receivables outstanding might typically be in excess of $1 million, or about one and one-half times one year's net profit.

When this provision is combined with other tax proposals recently enacted and the provision in the current proposal to eliminate the bad debt reserve method, the results become devastating in a geometrical ratio. Owner-operated service businesses are merely a conduit to compensate the owner-operator, working partners, or working shareholders, for the efforts they have expended in the conduct of a business. Rarely does the IRS even question the reasonableness of compensation to owner-operators receiving their fees as a result of the performance of a personal service, even when there are one hundred or more employees. Therefore, the uncollected receivables which would be income under the accrual basis method of accounting should automatically be offset by a corresponding payable to those owner-operators who would be compensated for their efforts expended in earning the income. However, the Deficit Reduction Act of 1984 precludes any accrual to a controlling shareholder, and limits accruals to all other employees to a seventy-five day period. Therefore, the obvious remedy which would correctly reflect the proper income, under any method of accounting, would be useless for tax purposes if the proposals are enacted in their current form. Furthermore, in many service industries, the gross fees for services rendered represent merely an "offer". Because of the nature of many fees, particularly in the medical field where both physician and patient rely upon third-party payers to agree to payment, eventual collections could amount to as little as 80% of the amounts billed.

Even if the President's Proposal were warranted and fair, the real problem involved is of an entirely different nature. The fact of the matter is that trying to make income for many of these operations taxable will result in organizations making an obvious and direct effort to avoid being covered by the law. Not even considering those who will keep accrual basis records in a clandestine matter and purport to be only on the cash basis to qualify, there will be, in our opinion, a vast majority of businesses who might otherwise come under this provision who would legally avoid compliance in one way or another. As to the financial threshold of $5 million, companies would deliberately restrain growth and continually divide into smaller units or set up subcontract groups who would bill their customers directly or figure out some other means to have less than $5 million in revenue.

There are many companies who would be covered by the new legislation because they regularly prepare reports and financial statements on an accrual basis. The tax cost of compliance would be so enormous that these companies would have no choice but to make a decision to not keep track of their accrual basis numbers which is tantamount to having the Government force them into operating their businesses on less information than is desirable. The results of companies conducting their affairs to stay beneath the dollar threshold and operating with less than complete financial information will create artificially tax-governed operations while raising only minimal additional revenues. It is the universal goal that tax reform allow businesses to make decisions that are based on economics and not on taxes. This one provision would have the opposite effect.

The one type of business now reporting on a cash basis for tax purposes which could not get around the new law would be those who are required by their creditors to report on accrual basis. Those companies, mostly new and growing companies -- the very ones we should be concerned about protecting -- would be the ones who would need accrual basis statements in order to obtain credit; they would be forced into this compliance. The mature companies who don't need credit because they've already made it, could discontinue accrual basis reporting and, as long as they are under the dollar threshold, escape the impact of the new law in that way.

CAPITAL FORMATION INCENTIVES NEEDED

Small Business United is very concerned over the ability of small business to attract needed capital for business development and expansion. That is why the original proposal proffered by the Treasury could not have been supported by Small Business United or any other small business advocacy groups. The elimination of graduated tax rates and the capital gains deduction would have had a devastating effect on business start ups and expansions. Even though the President's Proposal has restored those two critical items, the legislation has not adequately, in our opinion, addressed the capital formation problems of small business. For years, it has been becoming increasingly difficult for small businesses to attract capital. This has been primarily because of two factors. Small banks have been rapidly disappearing from the scene, acquired by major bank holding companies. The elimination of the local banker and the small bank with limited resources which, of necessity, can only deal with smaller businesses, has dried up a much needed source of business capital. With interstate banking now apparently on the horizon, this problem will probably become even more severe.

The other factor which restricts small business capital formation is the interplay of our tax laws, which make investments in small businesses by individuals very undesirable compared to other investments. If an investor loans money to a company, his upside potential is limited to interest and the return of his capital. In the event he loses his money, the tax laws require the investment be treated as a capital loss, thereby limiting him to a $3,000 deduction per year. On the other hand, if he invests in the capital stock of a small company in order to increase his potential gain and take advantage of the deduction on the downside provided by SEC. 1244 of the Internal Revenue Code, he faces other problems. It is unreasonable for him to expect any type of yield on this type of investment, because of the double tax on dividends. Consequently, he cannot expect to see any of his appreciation until he sells out. In addition to all the traditional problems, current policy threatens effective use of the SBA loans and guarantees, Industrial Development Bonds, UDAG grants, etc., as tools to get capital into small businesses.

The resolution of this problem might be in relief legislation which would permit the establishment of a new investment vehicle called the Small Business Participating Debenture (See Appendix I). This would allow individuals to make an investment for a limited prearranged period of time and obtain a share of the profits and the growth of the company, as well as receiving some direct interest on their investment. The interest portion would be taxed as ordinary income, while the profit portion would be taxed as capital gains, and any losses on the investment would be treated as if they were part of SEC 1244. This legislation has been proposed in many forms in each of the last three congresses, and a new version which would be revenue neutral, at worst, is about to be introduced by Senator Weicker and Congressman Eckart in the near future. SBPDs have been the number one capital formation priority of Small Business United for the last several years. It has also been the number one priority of the last two SEC Conferences on Small Businesses Capital Formation. It remains the highest ranking capital formation item recommended by the 1980 White House Conference on Small Business, which has yet to be enacted. Small Business United feels strongly that it should be made part of any comprehensive tax reform measure.

Small Business United also feels there should be a provision in the reform legislation which would permit a tax-free rollover of the proceeds from a small business if the seller reinvests in another small business. Or, in the alternative, an investor could sell to a small business and invest his money in qualifying securities in a manner similar to that permitted for sales to ESOPs under the Deficit Reduction Act of 1984. Under current law, there is an incentive to sell to large companies because the seller can receive marketable securities of high quality in exchange, with no immediate tax consequences. A small businessman would also be more likely to accept installment paper from a large business because it would be more secure than paper accepted from a new entrepreneur who would probably be leveraging the buy-out. The adoption of these rollover capabilities would offset some of the anti-incentives under current law, and allow small businesses to remain privately owned.

SBU OPPOSES TAXATION OF HEALTH INSURANCE PREMIUMS

Small Business United is very concerned about the inclusion of, on individual returns, the portion of health insurance premiums paid by employers. Although we do not see this as either a reform or as a simplification, we do fear it as a "foot in the door" for future attacks on employee benefits at both the corporate and individual levels. When and if this happens, it would create a serious impact on the small business community which is, for the most part, labor intensive. Many small businesses are today being stifled by the high cost of employee benefits. If these benefits were made taxable to the employees or non-deductible by the corporations, the effect of either one would be that it would come from the corporate till. Many small businesses would be unable to cope. Although Small Business United would not necessarily be opposed to this provision if we knew it would stop there, it would be wrong to underestimate our concern relative to the overall concept of taxation or non-deductibility of any type of non-abusive employee benefit.

APPENDIX I
TESTIMONY OF BRAD ROLLER TO SENATE COMMITTEE ON FINANCE
July 10, 1985

SMALL BUSINESS PARTICIPATING DEBENTURES

Issue

The Small Business Participating Debenture (SBPD) has been advanced as a proposed solution to the problem which many closely held businesses have in raising capital. The SBPD is a hybrid security issued by a qualifying small business that:

- Becomes a general obligation of the company.
- Bears a stated rate of interest not less than a standard imputed interest rate specified by the Secretary of the Treasury.
- Has a fixed maturity date.
- Grants no voting or conversion rights in the company.
- Provides for the payment to the investor of a share of the Company's total earnings, which would be taxed at capital gains rates.
- Provides an ordinary deduction to the investor for losses on the investment, subject to current limitations for stock losses on small business corporations.

The specified terms of the SBPD, such as the interest rate, maturity date and share of earnings, are negotiated at arm's length between the company and the investor with no government involvement.

An SBPD could only be issued by a domestic corporation operating an active trade or business, which has issued equity securities totalling less than $1 million. Only companies that do not have outstanding securities that are subject to SEC regulations are eligible to use SBPDs. Additionally, no company may have issued and outstanding, at one time, SBPDs with a face value in excess of $1 million.

Current Situation

America became great because of the foresight and courage of two very different segments of our economy. One was represented by the hard-working innovative entrepreneur or small business proprietor; and the other by the knowledgeable, wealthy individual or financial institution that supplied funds for small enterprises. Today, there are great numbers of small business owners/managers who fill the first role but, unfortunately, factors have emerged to diminish the number of financial risk-takers willing to support their ventures. Some of the circumstances that have caused this shortfall are discussed below.

The most important sources of funds in the past have been commercial banks, but with the gradual disappearance of the small, locally owned and managed banks, these funds have become less available. Large, structured banks are far less likely to finance closely-held companies under the terms and conditions that were satisfactory to their owner-managed predecessors.

More and more of the Nation's wealth is being accumulated by insurance companies, pension benefit trusts, and other similar institutions. Regulations and traditional investment habits prevent these funds from being directed toward risk situations. In fact, even low risk situations, if they involve small businesses, are generally not acceptable as investments in the institutional marketplace.

The motivation for the traditional investor to direct his funds toward small business has been greatly undermined in recent years. If the investor favors the role of lender, incredibly high interest rates must be charged to warrant the additional risk taken compared to money market funds or similar investments. Whatever interest is earned, however, will be subject to ordinary income tax rates. If the investment becomes worthless, the capital loss incurred will have relatively little tax benefit to offset the economic loss.

On the other hand, should an investor desire to purchase equity, there are only a few methods to realize a fair return on the investment. The equities can be made "liquid" by a sale of the company or a public issue, neither of which may be in the company's best interest and over which the investor may have no control. A return can also be had through dividends on stock. However, these are penalized by the prohibitive double taxation on dividends.

There are a limited number of private venture capitalists. Those that do commit capital to emerging business traditionally finance only higher risk situations with a potential for extraordinary growth, not traditional expansion. In many instances, a substantial amount of equity and control must be given to the venture capitalist in order to secure this financing. These conditions are generally unacceptable to the small businessman.

Proposed Action

So, what is needed is a new instrument for financing small businesses which will provide a fair, liquid return on an investment without the concomitant need for an "equity kicker" to realize a capital gain. THE SBPD IS THE RESPONSE TO THIS NEED.

Knowledgeable small businessmen, their advisors and sophisticated investors believe that SBPDs will finally provide a much needed, new source of capital for small business. An SBPD offers capital to the small business without requiring a pledge of equity or a misuse of existing sources of debt financing which, if available, are often unaffordable. To the contrary, SBPD investments would likely reduce the need and cost of other debt. For the investor, an SBPD offers a stated rate of return, plus a negotiated share of the profits for a limited period of time. All of the investor's return is taxed favorably.

STATEMENT OF JAMES GOLDBERG, CHAIRMAN, SMALL BUSINESS LEGISLATIVE COUNCIL, TAX COMMITTEE, WASHINGTON, DC

Mr. GOLDBERG. Thank you very much, Mr. Chairman. My name is James Goldberg. I am chairman of the tax committee of the Small Business Legislative Council, which is a alition of some 86 associations with a single common purpose—to represent the views of small business and to ensure consideration of small business concerns in all national policy decisions. Collectively, SBLC members represent more than 4 million small businesses in a diverse range of endeavors from manufacturing to wholesaling to retailing and to agriculture. We have a statement which we would request be placed in the record; and in keeping with your time strictures, I will try to summarize what is in that statement. The mood, I think, of small business and SBLC is basically positive. The President's message upon the introduction of his tax proposal sounded a theme which we can support. We believe the American people, and particularly the American small business owner, are ready for a change to a simple, fair, and more understandable tax system. Simplification is not only reducing the number of rate brackets. It means establishing a system which permits the average small business owner to make economic decisions with confidence. It is very difficult to present to you a small business position since small business, as we have indicated, are engaged in a variety of endeavors. Nevertheless, there are a number of things which we can point to in the President's bill which are common denominators for all of the types of small business which all of us on the panel represent. Many of them have already been touched on, and let me just underscore a few of them once again for you. Like the other members of the panel, we were very pleased that the President has recognized the importance of the graduated corporate rate and has included a graduated scale in his proposal, unlike that which was contained in Treasury I. However, as Senator Sasser pointed out, I think there are some concerns that, when you take away the ACRS method of depreciation and when you eliminate the investment tax credit and when you eliminate some of the other deductions which are granted to small business, what you end up doing is providing a larger bottom line for those small businesses. And by keeping the same tax rate structure, you end up increasing the taxes paid by small business to a disproportionate extent over that which is paid by large business. I think that Senator Sasser's proposal has merit, and we would strongly recommend that the committee, in its deliberations on the tax bill, take a look at the graduated rate structure and determine the impact on small business. And I think you will find that what is necessary is some reduction in the graduated rates that are set forth, so that small business is not called upon to pay a disproportionate share of the tax increase which is going to be levied on American business. We have talked about the capital gains rate, and we are pleased to note that the President not only saw fit to retain capital gains incentive but to lower the capital gains rate. In the area of fringe benefits, and pensions in particular, it is particularly disturbing that there are some aspects of the President's proposal which call with tinkering of the pension system in the guise of tax simplification. The problem, as was pointed out earlier on the panel, is not so much the fact that this is being done, but that it is being done on a repetitive basis by the Congress and the White House. And just when a small business owner thinks he understands what he is supposed to do under the Tax Code or what kind of a pension or retirement structure is best for his employees, the rules of the game change. And frequent changes—particularly in the pension and retirement and fringe benefit areas—really tend to skew decisions that are made by small business and cause many of them, I am afraid, simply to throw up their hands and say, well, there are too many changes in this area; I am just not going to offer this fringe benefit or that fringe benefit or pension to my employees. And I think that is detrimental to the work force and particularly to the small business work force; and we would call upon the committee to take a look at that. Finally, in the area of industrial development bonds, there are many members of the Small Business Legislative Council who are concerned about the elimination of IDB's. IDB's—I can tell you from my own experience—are of great benefit to many small businesses. IDB's—again from my own experience—my initial reaction was that this is a benefit only that goes to large corporations. In fact, many, many small businesses are able to take advantage of industrial development bonds and industrial revenue bonds; and it provides them with the opportunity to grow and to grow at a rate that they would not otherwise be able to do. And so, we would urge the committee to take a look at IDB's. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Walter E. Galanty, Jr. follows:]

Statement of Walter E. Galanty, Jr.
before the
Committee on Finance
U.S. Senate
July 10, 1985

On behalf of the Small Business Legislative Council (SBLC) I would like to thank you for the opportunity to testify before this Committee today.

My name is Walter E. Galanty, Jr. and I am Chairman of SBLC, a coalition of 89 associations with a single common purpose - to represent the views of small business, and to ensure consideration of small business concerns in all national policy decisions. Collectively, we represent over 4 million small businesses in a diverse range of business from my own industry, brick distributors, to manufacturers to retailers to agriculture. More importantly, we represent the entrepreneurial spirit of this country. In the end, the fairness of tax reform will not be measured in dollars and cents but on how effectively our tax system preserves the economic climate for entrepreneurial activity.

Our mood is positive. The President's message upon the introduction of his Tax Proposal sounded a theme which we can support. We believe the American people, particularly the American small business owner, are ready for a change to a simple, fair, more understandable tax system. Simplification is not only reducing the number of rate brackets, it means establishing a system which permits the average small business owner to make economic decisions with confidence. We'd venture to say that most small firms view the tax code as a hindrance rather than a help, and are ill equipped to mine the mother lode of the tax code in such a ready fashion as those with the resources (and the battery of accountants and lawyers) on hand to do so.

At the same time, small business has long recognized the value of the tax code to promote capital formation and retention. The more growth-oriented you are, the more you come to appreciate the value of sound economic based tax policy. Capital, whether for a new start or an expansion, does not come easily to small business. Financial markets (whether at home or abroad) don't provide the favorable rates or even the access to credit we need. Likewise, small business can seldom rely on large institutional investors to provide equity. Much of our capital comes from small investors, from retained earnings, or from a select group of institutions that specialize in small business financing, and tax policy has a tremendous influence on the flow of dollars from these sources.

The converging, as well as conflicting, aspects of these two forces come together within the context of this debate. How do we develop a fair, neutral and equitable tax that still encourages the growth of small business?

Our problem is made more difficult by the fact that small business is a rather sweeping concept. While we have our common denominators, the individual nature of our business leaves us with a variety of interests. Specific industries are affected differently when the plan is sliced vertically. We cannot pretend that what is good for the brick distributors is always necessarily good for the plumbing contractors. In the end, we have to view tax reform with a wide angle lens.

A prime example is the simplification of the marginal rate structure. Of a universe of 14 million small businesses, there are many "businesses" being conducted as sole proprietorships. As the President noted, they would surely benefit from a reduction in marginal personal rates. These are the classic mom & pop's, whose primary ambition is to make an honest living and pursue their dream of economic freedom. For them, simplification is an answer to their frustration and anxiety.

At the other end of the spectrum is the sophisticated growing business, a true engine of job creation. For that growth firm, once they have gotten beyond the early birth stages of the business, a sole proprietorship form or even a S Corporation form can be a hindrance to capital formation and retention. From a purely business point of view, the marginal personal rates have little to do with that type of business.

Before leaving the personal rate side, there is one other advantage that should be highlighted. Study after study have consistently demonstrated that the principal source of small business start-up funds is the informal network of family and friends. Recently, the small business column in the Wall Street Journal chronicled, once again, small business' dependence on such investment and the frustrations of locating these investors.

To the extent we can provide a stimulus for additional investments by this informal network, we are achieving a positive gain for small business. If lower personal rates put more funds into the hands of these investors then that is a positive gain for small business.

As I noted earlier, for the growth-oriented small business the C Corporation provides the flexibility and structure to acquire new capital and retain earnings necessary for expansion. Year after year, small business has made a graduated corporate rate structure its number-one policy goal. (Parenthetically, small business and SBLC has been quite consistent in outlining its tax priorities. We cite frequently the 1980 White House Conference on Small Business and last year's National Issues Conference throughout this testimony. The 1980 Conference is remarkable for its relevance to the present debate.)

As you will recall, the number one priority of the 1980 White House Conference on Small Business was - "Replace the present corporate and individual income tax schedules with more graduated rate scales, specifying the graduated corporate tax scale up to $500,000." The 1984 National Issues Conference also voted graduated rates as their third priority behind deficit reduction and government competition; and our own SBLC Issues Conference, held in January of this year, also voted this a high priority. We are pleased to see the President has recognized the importance of the graduated corporate rate and has included a graduated scale in his proposal. The remaining question relative to the rate structure is whether the inclusion of the base broadening elements of the President's package will result in a disproportionate tax increase for smallest business in the lowest two rate brackets as their corporate rates remained the same while the top rates for corporations were cut.

As to the topping off of the structure at 33%, there are positive and negative ramifications for a growth oriented firm. From one perspective, an extended progressive rate structure allows a growth oriented firm to compete against established firms during the growth years. On the other hand, the prospects of leveling off at 33% has to be appealing to a growth oriented firms as retained earnings do play a vital role in the expansion of existing businesses.

The second area of interest in the President's proposal deals with the rate differential on long-term capital gains rates. SBLC strongly believes that almost the sole motivation for outside investment in new and growing businesses comes from that tax differential. Clearly, investing in such companies is a risky undertaking. Successful investments hold the potential for major returns, but there are more losers than winners in the portfolios of these outside investors.

The long-term capital gains tax differential provides the "equalizer" in offsetting the higher risk of investing in smaller firms. Again, we're pleased to note that the President not only saw fit to retain the capital gains incentives, but to lower the rate to 17 1/2 percent. We found it of particular interest that the Administration's first preference appeared to be to craft a capital gains system which would encourage investment in small and innovative companies.

Unfortunately, they encountered difficulties we know all too well in defining the particular activity or forms of investment which should enjoy such treatment. We hope the effort will not be abandoned completely, and we would certainly pledge to work on this effort. As you will recall, in 1980, the White House Conference voted the deferral of taxes for rollovers of investments affecting small business, and a tax credit for initial investments in small business as their sixth priority. We note that Senator Sasser has introduced a bill, S. 1130, which addresses these very issues.

While the limits placed on investments eligible for capital gains might have a negative effect on some asset based transactions for the upgrading of depreciable business property, we believe the overall effect will be to move individual investment funds away from passive assets, such as artwork and the like, to the dynamic growth of small business stock. The only question left in our minds is whether special capital gains treatment should be offered for qualified long term investments in small business (e.g. a lower rate for assets held for five years).

One final word on taxation of long-term capital gains. We have seen figures showing that 41% of the dollars dedicated to organized venture capital companies comes from corporate taxpayers. The President's proposal keeps the corporate capital gains tax rate at the present 28% -- and that's a very small differential from the top corporate tax rate of 33%. We believe your Committee should come up with a better formula which will provide incentives for corporations to invest more dollars, not less, in venture capital for new and growing small business concerns.

Of the proposals in the corporate side of the President's plans, we find that the depreciation and investment tax credit present the greatest difficulties to a diverse small business community. Certainly, for a capital intensive industry with a substantial small business sector, such as the machine tool industry, the ACRS and the investment tax credit have made a significant contribution to growth.

We believe we can make the following observations in this area. In 1980 a simplified capital cost recovery system and direct first year expensing were parts of the number two priority of the White House Conference delegates. If the consensus is that investment tax credit has outlived its usefulness, the importance of the current alternative, first year direct expensing, becomes even more critical. The President has retained this provision, but would freeze it at current levels. It should be increased in accordance with the scheduled timetable as set forth in the 1981 tax bill. We might also note that we have been long time proponents of equal treatment of new and used equipment and machinery, and would hope that both types would be treated equally under whatever system ultimately evolves from this process.

As to the capital cost recovery system, we are pleased that the Treasury I approach has been abandoned, as a simplified accelerated system is important. The President's new proposal may reach a happy medium. Data is difficult to come by, but it has been our impression that large capital intensive firms received the disproportionate beneficiaries of the ACRS system. We are hoping the proposal will result in a more balanced investment incentive scheme.

Finally, before leaving this area, we wish to note that while the service area has emerged as the dominant growth area for small firms, the "smokestack" industries cannot be written off as an opportunity for small business. The recently released "The State of Small Business: A Report of The President" observed that in so-called declining industries "there is a consistent pattern of higher job growth in small firms of fewer than 20 employees than in other size classed of firms". The President's report goes on to state: "Within manufacturing, small firms are adding new jobs in both mature smokestack industries and new high technology industries, indicating that small firms are redistributing resources in order to expand." Therefore, we must carefully balance our tax proposal so as not to "write-off" that segment of our economy as a place for small business activity.

The proposal to limit further the use of cash accounting is of concern to us. We believe there is solid business management justification for the use of cash accounting by small businesses. We believe the proposal to put more firms on accrual accounting will create many problems for small firms and while the $5 million threshold alleviates some of the problems, at best, it is a postponement of the problem.

Finally, the ultimate legislative form of the package, how it is integrated with the current system and how the transitional rules are crafted, have the potential for creating the most significant problems for the small business community. What appear to be minor changes in the aggregrate can be devastating to individual firms, especially when it effects cash flow. We are prepared to offer our services to this committee to develop a final product to minimize the number of those adverse consequences.

These are just a few of the major areas of interest to us. As I noted at the outset, there are many cross-currents which will pull the small business community in many different directions. In the end, there will not be a tote board upon which we can add up the figures and pronounce that the burdens and benefits add up as neutral, unfair or fair to small business.

In that regard, the President's proposal is a significant improvement over Treasury I, which discriminated heavily against small businesses. While the new plan addresses the obvious small business issues, there are several proposals which do not have a direct effect on small business, but could dramatically affect the cost of doing business.

Two examples which come readily to mind are the changes in the tax treatment of property/casualty insurance company and fringe benefits. In what ways will these costs be passed on to the small business community? Certainly almost all businesses have property/casualty insurance and small business does not have the individual clout to stave off insurance increases. Likewise, employee fringe benefits are a difficult area of small business-employee relations. How will taxation of these benefits change this relationship, keeping in mind the labor intensive nature of the small business community?

This testimony is not meant to be an answer to all questions. We believe, like the President, change is in the wind. The current tax code is too much of a patchwork and not enough a strategy for the orderly growth of our economy. Tax incentives are important for encouraging capital formation and retention by the small business sector, and the rewards, in terms of job creation, economic growth, stability, and tax revenue, are worth the effort.

Let me make our message clear. We are pleased by the President's prominent recognition of small business in his proposal and we support the President in his tax reform effort. On the whole, it is a solid program which will allow small business to grow and contribute to our economy. We are aware that some small business dominated industries have specific concerns which relate solely to their industry. It would be difficult for us to address those issues but we do believe they are legitimate, and hope the Congress will consider the merits of the presentations made by these groups. We know that in a subject as complex as this, much work must be done to craft a final product that will produce real reform and encourage the growth of small business. We look forward to working with Congress to achieve this goal.

The CHAIRMAN. Gentlemen, in your testimony—although everybody didn't allude to it orally, but in your written testimony—all three of you express some misgivings about restrictions on use of the cash versus accrual methods of accounting and about how that would adversely affect small business. First, from the standpoint of simplicity, surely a cash accounting system is simpler than an accrual accounting system, isn't it?

Mr. MOTLEY. Yes, Mr. Chairman, that is the main reason why we express that concern. We have had surveys a little earlier indicating that a full one-quarter of our membership doesn't even use accountants. So, the simpler the system, the easier it is for them to deal with.

The CHAIRMAN. But we are getting more and more criticism from small business and agriculture about compelling the cash accounting system or moving toward it. This bill doesn't quite compel it, but it wants to tighten up on it.

Mr. ROLLER. But doesn't this bill tighten up on accrual?

The CHAIRMAN. I meant accrual. Excuse me.

Mr. ROLLER. Right.

The CHAIRMAN. And I do apologize. And you are convinced that most small businesses could get by very well using the cash accounting system.

Mr. MOTLEY. Yes, we are, Mr. Chairman.

The CHAIRMAN. Including agriculture?

Mr. COHEN. Yes. Mr. Chairman, even though the cash basis method of accounting is far simpler, it is also far more equitable because it gauges the real income of individuals in a service business. The accrual method for the individuals in a service business would force them to pay taxes on funds that they do not have. This is different from a mercantile business that has inventories and has suppliers. Many of those businesses offset uncollected income by unpaid bills, but when your major expenditures are for items such as rent, taxes, and particularly employees and employee benefits, those all have to be paid on a regular basis; and it doesn't really matter on the expense side whether you are on the cash or the accrual. But on the income side, if you are forced to recognize revenue with the time that you have performed the service—even though you might not get the income until later—it could be devastating.

Mr. MOTLEY. Mr. Chairman, there is a current exclusion in the law for farms up to $1 million, and it is a very simple system. And we believe that—at least from our membership's standpoint—they use it quite a bit.

The CHAIRMAN. And Senator Abdnor was suggesting going to $2 million, as I read his testimony for farms.

Mr. MOTLEY. We have suggested going even higher than that in the past.

The CHAIRMAN. I have no more questions now. The order we have is Senator Bentsen, who was here quite early, then Symms, Baucus, Chafee, Long, Mitchell, and Pryor. So, we will go to Senator Bentsen.

Senator BENTSEN. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. John, you mentioned that you compared current law with the President's proposal. Do I understand that the NFIB would take current law over this proposal?

Mr. MOTLEY. No; they would take the proposal over current law.

Senator BAUCUS. Oh, Excuse me. They would take the proposal over current law.

Mr. MOTLEY. The proposal over current law. Yes.

Senator BAUCUS. I must have misunderstood you. What is it primarily in the proposal that is better than current law? What one or two major items make the difference?

Mr. MOTLEY. It is really very basic, I think, in that most small businesses tend to be either labor intensive or inventory intensive and not capital intensive. If you break out the community, you are probably looking at 20 percent being capital intensive—your manufacturers, your construction firms, your transportation firms. The rest of it is retail, wholesale, and service. Those are very high effective tax paying industries. The code as it is structured today gives tremendous capital incentives which allow the capital intensive firms to reduce their effective tax rates. Those labor-intensive firms and inventory-intensive firms cannot take advantage of them, at least to the same degree. An example: the investment tax credit. Ninety-four percent of all of the revenue from the investment tax credit goes to firms with over $1 million in assests, and you would find this with depreciation and foreign tax credits. So, if you add all of those exclusions, credits, deductions—if you happen to be a corporation involved in manufacturing and also engaged in exporting—you can do pretty well as far as reducing your taxable income is concerned. If you happen to be a local retailer, you are not going to be able to exclude very much, and you are going to have very high effective tax rates. Therefore, the large reductions in marginal tax rates are tremendously beneficial to small business.

Senator BAUCUS. You listed several concerns. One is that you felt that marginal rates should be dropped even further to offset the greater rate cut that big business is getting, compared to small business. You also talked just a little bit about greater availability of cash accounting. Third, a greater use of fringes in unincorporated small businesses. And you mentioned a bill that I and others have introduced, allowing small businesses to deposit their FICA taxes on a monthly rather than a biweekly basis. Then you made some other suggestions. Which of all those you suggested—I would like to ask the whole panel this basic question—are the one or two most important for small business generally?

Mr. MOTLEY. I would think that the simplifications that we mentioned would be the most important for small business. Your provision on the depositing of FICA taxes, we believe, is tremendously beneficial. Expensing is tremendously beneficial and also the cash accounting method. Each of them have several different impacts. They have an impact on the hidden tax which is out there, which is the money that smaller firms have to pay to accountants and lawyers to comply with current law. They also tend to increase the cash flow of those small firms. They don't have to borrow as often. In addition, they also tend to reduce the higher effective tax rates that they pay. So, the simplification—putting them in a group—would be those things which we would be most strongly in favor of.

Senator BAUCUS. How hard would it be to change the Regulatory Flexibility Act as it applies to IRS so that interpretive rulings as well as legislative rulings would be subject to that act? That is, I would require the IRS to got through a procedure to determine how adverse an effect an interpretive ruling would have on small business? How important is that?

Mr. MOTLEY. That is very important. The one part of my statement that I wasn't able to get to because of the time limitation was the fact that IRS really tends to be the bane of small business. Tremendous paperwork, tremendous redtape. Sixty percent of all the forms that small firms fill out come from IRS—6 out of the top 10 most onerous come from IRS. They tend to consider themselves exempt from most of the major pro-small business laws that Congress has passed—Paperwork Reduction Act, regulatory flexibility. We are even treated differently for court costs and attorneys' fees—something that you have been involved in before also. I would very much like to see the committee take a serious look at making IRS—finding ways to make IRS comply with these other laws which have been passed, which have been tremendously beneficial in other dealings with the executive branch of the Government for the small business community. I think it would be something that has certainly no revenue impact, that the committee could do in a tax reform proposal, that the small business community would be eternally grateful for.

Senator BAUCUS. Just one quick question. Does anyone else on the panel—in 60 seconds—want to list his priorities of what we should address here and accomplish here?

Mr. GOLDBERG. Senator Baucus, from my standpoint, if you asked me what one thing would benefit small business the most that you could do, I guess I would have to disagreee with Mr. Motley and talk in terms again of reducing the graduated rate schedule.

Senator BAUCUS. That is the most important for you? All right.

Mr. GOLDBERG. I would think so because I think that is what small business sees as the bottom line at the end of the year when they go to pay their taxes?

Senator BAUCUS. Mr. Roller.

Mr. ROLLER. I would say the graduated rates, the cash ing, adding some capital formation items like capital gains rol[illegible] and possibly small busines participating debentures, and they have extreme fear of any taxation of the health benefits. We really think——

Senator BAUCUS. Extreme fear of what?

Mr. ROLLER. The taxation provision of health benefits, that it is just a bad trend.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. Mr. Motley, at the conclusion of your testimony, you discuss your concern over the transition rules. What do you think we ought to do on the transition rules?

Mr. MOTLEY. Well, Senator Chafee——

Senator CHAFEE. I mean, as you know, this program—if we passed it—could be effective on January 1, 1986.

Mr. MOTLEY. I think that would be a disaster for the small business community, Senator. Most small business people who operate out across the country tend to operate very much by the seat of their pants. And you know, what they generally get on changes in the Tax Code either comes from reading the paper, seeing it on the news, or when their accountants become educated on it, they let them know. So, there has to be a period--an education period, a time for them to adjust, a time for them to sit down with their accountants and lawyers to find out what their new obligations are going to be under the law.

Senator CHAFEE. One of the objections we have heard to this is it creates confusion in the marketplace, that people are withholding making investments because they don't know what the situation is going to be. If we had this thing delayed to the first part of 1987, the bigger corporations say this would be deleterious to them. What do you say to that?

Mr. MOTLEY. It may be possible for the committee to deal with the capital investment side of the proposal separately so that doesn't take place. If I remember, back in 1981, when we were considering the last major tax bill, the chairman of the Senate Finance Committee and the House Ways and Means Committee made a statement. They agreed what the effective dates for the capital incentives section for ACRS was going to be, so that that didn't hinder it. Something like that may be possible with depreciation and other capital incentive parts.

Senator CHAFEE. If you had your druthers, when would you have this take effect?

Mr. MOTLEY. January 1, 1987, Senator, considering that it is passed in the first quarter to first half of 1986.

Senator CHAFEE. Let's assume it was passed in 1985, calendar 1985. Signed by the President on December 1.

Mr. MOTLEY. I think we would still prefer January 1, 1987, although under those circumstances, possibly July 1 or September 1, 1986.

Senator CHAFEE. Mr. Goldberg, what do you say?

Mr. GOLDBERG. Senator Chafee, I think one of the problems with an accelerated effective date is simply that the IRS can't write the regulations fast enough.

Senator CHAFEE. That is their worry. They said they could. They have testified up here, and let's assume they could, just for the sake of this discussion. What would you say then?

Mr. MOTLEY. I think on the assumption—and I think frankly it is an erroneous assumption—but on the assumption that the IRS can get the final regulations in place, prior to the effective date of the—any provision, then a January 1, 1986 would not be a problem. I just don't think that the IRS can get the final regulations in shape prior to that time.

Senator CHAFEE. I doubt if they would be final regulations. Mr. Roller, in your statement, in the summary, you said you are prepared enthusiastically to endorse the administration's tax reform proposal. Then you proceeded to rip it to shreds. Are you for it or are you against it?

Mr. ROLLER. I think it was somewhat enthusiastically. We would like to see reform——

Senator CHAFEE. If that is enthusiasm, it is subdued enthusiasm or mitigated enthusiasm, I would say. What is your position?

Mr. ROLLER. We would——

Senator CHAFEE. Before we make the changes you suggest?

Mr. ROLLER. Of course. We have a few problems with it.

Senator CHAFEE. A few problems?

Mr. ROLLER. We are not unlike Mr. Motley that we kind of endorse it in concept, and there are a few things that we think need to be changed.

Senator CHAFEE. I see. Getting back to Senator Baucus' question. What is the biggest single thing you would like to have us change in it? The two biggest things?

Mr. ROLLER. I will give you two—two biggest things. Certainly, I think they would have to be the graduated rates and possibly lowering them even more than they are under this proposal, and I think that the cash—trying to eliminate the cash basis from a lot of our members would be a real big problem and totally unequitable.

Mr. MOTLEY. Senator Chafee, if I might just comment on corporate rates for one second, there is no doubt that I would agree with both Jim and Brad as far as reducing corporate rates for corporations being very important, but our problem is that American small businesses aren't corporations. And therefore, if that is the No. 1 goal to help small business in this country, you are missing—depending upon what figures you use—anywhere from half to three-quarters of the firms that are sitting out there.

Senator CHAFEE. Yes; but aren't you picking them up when you cut the individual rates?

Mr. MOTLEY. You certainly are, as you are all other taxpayers. Even the owners of the corporations, you are picking up there. That is why individual marginal rates are so important because everybody gets it, whether you are a corporation or whether you are an individual.

Senator CHAFEE. I just want to finish th~~is, if I~~ could, Mr. Chairman. The individual rates are set forth in the administration's proposal. Are you satisfied with those or do you want them to go further?

Mr. MOTLEY. We would be satisfied with those, Senator.

Senator CHAFEE. And then for those small businesses that are incorporated, you would like those rates to come down as they are in the existing law? That is, reduced—retain the whole series of differentials.

Mr. MOTLEY. Either that or something else be done which would offset the fact that there is no change at the bottom end but would be beneficial to a lot of small firms. bringing the rates down to 10 percent is a $750 drop in taxes for a corporation under $25,000 a year. It is not a lot of money, I guess. We made a judgment that to get them that low might not be worth the political effort that would have to be put into doing it.

Senator CHAFEE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long. Questions?

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman. When the President announced this plan on May 28, he said it was revenue neutral. That is, it would produce the same amount of revenue that the current system now provides. That, of course, is a matter of concern to everyone because of the large and dangerous Federal deficits that we have. But since then—in the intervening 6 weeks—a number of analysts have looked at the plan and concluded that it is not revenue neutral, and indeed the Secretary of Treasury acknowledged before this committee that was just an estimate. They might be off as much as 1 percent of the total revenues during that period, which could be as high as $50 billion, perhaps even more. I know, Mr. Motley, your organization has been very vigorous in urging that we deal with the deficit. Now, we come here and you have a statement on the tax plan and you make a number of recommendations, many of which would have the effect of reducing revenue to the Government. Are you concerned about that? Are you concerned about the deficit? And if you are making proposals that have the effect, if adopted, would reduce revenue further and therefore increase the deficit, do you have any suggestions for us as to how we can compensate for that and make up the revenue in other areas, so we do not take what I think would be the dangerous step of increasing the Federal deficit in the name of tax reform?

Mr. MOTLEY. You are absolutely correct, Senator Mitchell, in expressing NFIB's concern over the deficit. It is still our No. 1 priority, and tax reform would have to take a second place, I believe, if the two were to clash and become mutually exclusive, from our standpoint. What happens in the economy in interest rates in terms of the deficit is the most important problem facing small businesses. As far as the proposals that I mentioned in here, I think that there is a caveat in the written statement which indicates that a lot of those depend upon the revenue impact of them. I prefaced my remarks on expensing by saying that if you have the economic equivalent of expensing—supposedly a CCRS—very possibly the revenue numbers are a lot different; and therefore, the simpler solution for small business is expensing. If the revenue numbers are different—and I might add that there are several members of the House Ways and Means Committee that are having revenue numbers run at different levels on expensing right now—then it certainly would not fit into the proposal and we would not ask for it. The same would be true of cash accounting. We believe that the revenue impact of indexing FIFO would be the same as the revenue impact of simply going to the cash method for smaller firms, or very close but the revenue wouldn't be terribly different. I don't believe that the other suggestions that we have made have a large revenue impact, one way or the other. As a matter of fact, when we set out to take a look at those things that we wanted to see changed or fixed or fine tuned in the bill, that was one of the caviats that we used. As far as the overall revenue loss of the proposal, we would very much like to see a revenue neutral bill. I think, you know, you can play with the figures and with change in economy activity over a period of time, there are tremendous shifts in the amount of money that would come in under this proposal over the amount that the Treasury would lose. I would just have one comment. In our efforts that we have put forward, as far as the Small Business Administration is concerned, we all here have agreed to the Senate numbers as far as cutting SBA. We cannot get the Housê to go along with that, and they have passed a proposal out of the Budget Committee over there for $900 million, and that is a $1.6 billion increase over the $2.5 billion Senate proposal.

Senator MITCHELL. Let me ask it this way. And I will ask each of you to give me a yes or no answer. You have expressed varying degrees of enthusiasm in support for the President's plan. If it turns out that those analysts that suggest that the President's plan is not in fact revenue neutral and would increase the Federal deficit, would you urge us then to vote for the President's plan under those circumstances or vote against it?

Mr. MOTLEY. I would urge you to bring out a revenue neutral bill.

Senator MITCHELL. So, in other words, you would be against the President's plan as proposed if it increased the Federal deficit? That is what you are saying substantially.

Mr. MOTLEY. Yes.

Senator MITCHELL. Mr. Goldberg.

Mr. GOLDBERG. I think I would have to say that we would be against the bill if it involved an increase in the Federal deficit.

Senator MITCHELL. All right. Mr. Cohen and Mr. Schneier, go ahead.

Mr. ROLLER. I think that we could make a good case that the analysts have not been universally correct in a lot of their assumptions in the past. My gut feeling is that most anything you would do from a small busniess standpoint that puts capital in the hands of entrepreneurs in the long run turns out to be a revenue generator for the Federal Government, in the form of jobs and purchases of equipment and so on.

Senator MITCHELL. Is that a yes or a no, Mr. Roller?

Mr. ROLLER. I would also urge you to come out with a revenue neutral bill.

Senator LONG. Could I say something on that point? When the witness said that the analysts have not been accurate, the White House has been uniformly inaccurate in the past; they tend to be too optimistic.

Senator MITCHELL. That is a very good point. Nobody has been 100 percent accurate, but the least accurate have been the predictions made by the White House. [Laughter.]

Mr. ROLLER. I think past history has shown that most legislation that has put capital into the hands of entrepreneurs has, in fact, produced revenue for the Government though.

Mr. MOTLEY. Senator, if I might say this just to back up Brad's point? NFIB has been running for the last 11 years a quarterly economic report on small business, tracking rates of inflation and growth in GNP. And it is strictly using the small business community, which is a terribly unsophisticated method according to some economic circles. We have been uncannily accurate in precursing or predicting what those shifts are going to be. So, I would have to——

Senator MITCHELL. Maybe you ought to apply for Stockman's job. We need some expertise down there, Mr. Motley, with that record. [Laughter.]

Thank you.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. Mr. Motley, NFIB—how many employees—you may have covered this in your testimony but I didn't see it—how many employees on the average does each of your members employ?

Mr. MOTLEY. Nine to ten, Senator.

Senator PRYOR. Nine to ten?

Mr. MOTLEY. Nine to ten individuals.

Senator PRYOR. So, you are talking about very small shoestores and local drugstores and really the grassroots of American small business. Is this correct?

Mr. MOTLEY. We are talking primarily about Main Street. Yes, Senator.

Senator PRYOR. Over the recess, back home the papers there carried a poll—I think it was done by the Washington Post, but I am not certain—that the perception of the tax bill now before this committee, which used to be called the tax simplification bill and now, I guess, is called the tax reform bill, or Treasury II, that about 60 percent of the people that were interviewed said that they did not feel that this particular bill would help them. Now, my question is this: Have you done any polling with your membership out in the country on whether they think this bill will help or hurt them? Do you have any results or any polling data you might share with the committee on this?

Mr. MOTLEY. We have nothing that would answer the particular question that you posed. What we did do was in the end of 1984—in November and December—do a rather extensive poll of what the membership felt was important to them, what the tradeoffs would be—in other words, at 20 percent, or 30 percent—what deductions you would be willing to give up. And according to the results of that poll—which we would be happy to share with the committee—the proposal comes out very well. I might also add that, since the proposal was put forward, we have only received one negative letter from an NFIB member and that was from an independent oil and gas business person in Texas.

Senator PRYOR. Now, on what proposal?

Mr. MOTLEY. On the President's proposal. Out of all of the members that we have, out of all of the industries that they represent, only one negative piece of mail has come across my desk.

Senator CHAFEE. How many favorable letters have you gotten? Ten or thousands?

Mr. MOTLEY. It is a constant trickle. [Laughter.]

Senator CHAFEE. Do you mean a total of 10 or a total of thousands?

Mr. MOTLEY. It is not quite a flood, Senator. [Laughter.]

No; I would say that every time we send something out, there are comments which come back which say to support the tax reform proposal, but there are no extensive letters. The one letter that I was talking about was an extensive attack on what the proposal would do to that particular industry.

Senator CHAFEE. It only counts against it if it is a long letter.

Senator BENTSEN. I would say that my mail is running about 3 to 1 against it. And when they talk about all of this grassroots movement, you don't have to be here long before you learn the difference between grassroots and astroturf——

[Laughter.]

Senator BENTSEN. I think most of mine is pretty synthetic.

The CHAIRMAN. David, we are still on your time, aren't we?

Senator PRYOR. I have one more question. Do you have any figures—you are talking about since 1978—the Congress and tax changes and so-called new tax legislation is added or deleted, or caused 2,600 changes in the Tax Code, and that must be extremely worrisome out there to those small firms with 9 to 10 people that you represent. Do you have any figures that you might share with the committee on what it costs annually for those small businesses to comply with the new laws, with the new deletions, with those changes? What are we talking about in terms of accountants' fees, lawyers, reports, and as you say, one of the growth industries is reports—or would-be reporting services, as to what the changes mean. Do you have any figures on what the costs might be?

Mr. MOTLEY. I don't have any overall figures, Senator and Abe makes the point that it would vary greatly depending upon the industry that the business was in, but we were talking just before the hearing about just simply changes in pension legislation—since 1980, which we figured there were four or five major changes. And for a typical small business with eight or nine employees, we feel that it will cost between $1,000 and $2,000 a year, just to update their plans and to comply with the law. So, you are talking $8,000 to $10,000 just for the changes in the pension area over that period of time.

Senator PRYOR. If any of the other panelists have a comment or other figures on that, I would be glad to have it, and I know the committee would.

Mr. ROLLER. Mr. Pryor, quite frankly, it wouldn't surprise me if a lot of those little people that you are referring to aren't even complying because they aren't even aware of what the real laws are.

Senator PRYOR. I would agree with that.

Mr. COHEN. And I have some specific figures because I am managing partner of a CPA firm, and I can tell you that in October

1977, we had a total of 12 people on our staff, and today we have 66. So, I am here strictly for altruistic reasons.

Senator PRYOR. Thank you.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Mr. Chairman, I think Senator Pryor has touched on a very important point. I know you have all raised it before, and I know from direct experience that it is true: Small business bears a disproportionate burden of paperwork. Complexity and changes in tax laws and pension laws confronts then with a major problem. It seems to me that you, as small businessmen, should kind of get your heads together and come up with some one or two ideas for very significant changes in how we pass laws here as they affect small business because most small businessmen can't pass on the costs. Big business is in a better position generally to pass on those costs, but farmers and ranchers can't pass on those costs. Most small businesses are in a position where it is difficult—compared to big business—for them to pass on those cost increases. Big business can hire accountants and attorneys and financial people and pass the costs on, but small business can't. So, I just want to encourage you to figure out some overall approach to this problem. Maybe we could just cut off at a gross sales or income figure and make rules radically different. I don't know, but it seems to me that the burden is upon both of us as Members of Congress and you as small businessmen to figure a way to address this.

Mr. COHEN. Keeping the law the same for a number of years will do——

Senator BAUCUS. Excuse me?

Mr. COHEN. Just not changing the law——

Senator BAUCUS. But how do we do that? Do we need a constitutional amendment or something? Otherwise, we are here every year changing the law.

Mr. COHEN. You need some discipline.

Mr. ROLLER. Mr. Baucus, if you would like to get it passed, we will try to come up with that.

Senator BAUCUS. I am sorry?

Mr. ROLLER. If you would like to get that legislation passed, we will try to come up with something.

Mr. MOTLEY. Just one other point, Senator Baucus. Part of that we tried to deal with back in 1980 when Congress passed the Regulatory Flexibility Act. And the point that I was making before to you is that you have certain agencies like IRS and DOD who consider themselves exempt from it. Therefore, they do not do a regulatory flexibility analysis. They do not bother to tier. Their solutions, which would hopefully—if they find a disproportionate burden on smaller firms—would take care of many of the problems that you suggest. That is one of the answers. A moratorium on changes would certainly be another one. If, after you pass the major revision of the Tax Code, if you could simply find some way you are not going to revisit this except for technical corrections—and what that entails—for a number of years it would be helpful to many small businesses across the country.

Senator BAUCUS. It would be helpful to us, too. Thank you very much.

The CHAIRMAN. Are there other questions?

[No response.]

The CHAIRMAN. If not, gentlemen, thank you very much.

Mr. MOTLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Next, we will move onto a forestry panel, consisting of Burnell Roberts, president of Mead Corp.; Eley Frazer, president of F&W Forestry Services; and Dr. James Yoho, professor of forest investment at Duke University.

Senator PACKWOOD. I have a statement to make before this panel starts, having just returned from Oregon and having visited several sawmills and having met with the timber industry. Every one of us works hard to bring jobs to their State, and I hope I am no exception in trying to bring jobs to Oregon, but I suddenly find that I am confronted in this administration bill with the potential job loss—thousands of jobs—in Oregon because of three provisions in this bill aimed directly at the timber industry. One is the repeal of the capital gains treatment the timber industry currently enjoys. This treatment is not unique to timber. They are simply treated like all other capital assets are treated. This bill takes that away and treats them unfairly and uniquely. Second, they will be required, if this bill passes, to capitalize rather than deduct the annual expenses incurred in managing of their forests; and unless you are a very, very cash rich company, I don't know how you are going to manage year after year after year after year to put money into your forest and take care of it in the hopes that when you sell your trees, 10 or 20 or 30 or 40 years later, you may recapture those funds. And third, the administration proposes repealing the 10-percent investment tax credit and the 7-year amortization of reforestation expenses, although this credit is only $10,000 a year. That is the kind of a credit that a small wood owner would get a little encouragement from. It is hardly a giveaway to major timber corporations. As far as I am concerned, the key to this bill and whether this bill is going to be successful or not and whether it is going to pass or not is: Is it going to create jobs or is it going to destroy jobs? In the timber industry, it absolutely destroys jobs. The estimates are 5,000 to 10,000 jobs in the industry. A fair portion of those are going to be in Oregon because forestry is our biggest product. So, when Secretary Baker met with me about this bill, I indicated to him that if timber was treated the same as other capital assets, I would not object. If the administration wanted to change the laws on capital gains, we would look at that from a standpoint of equity, and was it fair for all assests. But if the administration attempted to single out timber and treat them differently and treat them unfairly, that I had no obligation to try to support that position and no obligation to support the entire bill if that provision was in there. I hope that provision will be removed because I am not going to stand by and see the possibility of hundreds or thousands of jobs in Oregon go down the drain because timber is singled out unfairly for unique treatment, unfair treatment applied to almost no other asset. I know we have Senator Exon with us today, and I believe, Senator, you have a witness that you would like to introduce.

STATEMENT OF HON. J. JAMES EXON, U.S. SENATOR FROM THE STATE OF NEBRASKA

Senator EXON. Mr. Chairman, thank you very much. As you know we have very busy schedules around here, and I appreciate very much your allowing me to make a few brief remarks ahead of the panel that is going to talk on timber, which I know little if anything about, but I know what an important sector of our economy the timber is in. So, I apologize to the witnesses that are scheduled to tesify now, and I appreciate the fact that the chairman is allowing the customary courtesy of allowing other Senators who have other commitments to keep those and putting me in now. Mr. Chairman, I was very interested in listening to the preceding panel. I am a small businessman myself. My whole training, background, and experience has been in the small business industry, and I feel that the simplification plan advanced by the President is not good for small business, and I am very pleased to see the small business leadership come forth before the committee and so testify. I frankly felt that those who testified were somewhat hesitant to criticize. I would suggest that, if this had been Jimmy Carter's tax bill, the small buiness representatives who are sitting at that table would have gone up and down the line and denounced the bill with the Carter tax plan. Whether it is a Carter tax plan or a Reagan tax plan, this plan is not good for small business. It is certainly not good for the agricultural industry of this country. It certainly is not good for the insurance industry of this country. And I suspect it is not very good for the timber industry and other interests as well. Mr. Chairman and members of this Finance Committee, I am very pleased to be here this morning to formally introduce to you a fellow Nebraskan, Mr. Chuck Hassebrook, who will be on the panel that will follow the one that is before us at this time. And I also am pleased to make a few brief remarks on the matter that you are considering today. I guess, Mr. Chairman, that while criticism of other people's plans is probably not the order of the day, I would simply sum up by saying that the tax simplification is not as simple as some people thought it might be in the original instance. And in addition to Mr. Chuck Hassebrook, I am advised that Mr. Cal Coulter is here today. Mr. Cal Coulter will undoubtedly be testifying on behalf of the opinions of our important cattle industry with regard to this tax bill and I am sorry, Cal, that I will not be here to hear your testimony, but I will read it because I know that there are serious problems that the cattle industry has with certain provisions of this bill. It is very likely that the Senate will consider a new farm bill sometime in the next few weeks. While that legislation is vitally important to the farmers and ranchers of our country, the decision we will be making to change our Tax Code may be just as important as the consideration as to what kind of an agricultural program we are going to authorize for the next 4 years. I am pleased that your committee has scheduled this hearing and is specifically reviewing the impact of the proposed President's tax reform plan on agriculture. As you know, special farm tax provisions combined with other parts of the code, such as depreciation allowances, make farm losses an effective way to shelter nonfarm income under the present law. Many believe that nonfarm investors encouraged by our Tax Code have been a cause of some of the problems in the farm sector. What we need is simplicity, some common sense in the way the Tax Code treats agriculture.

What we do not need is the more strangling redtape and decisions made here in Washington that will drive even more farmers off of their land and out of the business of producing food. The impact of the current Tax Code varies from farmer to farmer. We must certainly consider reforming our Tax Code and making it more simple, but in so doing, we must ensure that we do not increase the tax burden on our Nation's farmers and ranchers or the burden of more redtape that they might have to follow. Concern has been expressed to me about several parts of the President's tax reform plan, including the depreciation system, the accounting methods, and the conservation deduction. In addition to these specific farm tax provisions, I am concerned about the overall impact of tax reform on our Nation's deficit. The last thing that agriculture needs is a tax reform plan which increases the deficits. We must work to see that tax reform is truly revenue neutral, as has been testified to by the previous witnesses, or there is little point in making major tax changes that end up in causing even more difficulty with the rising deficit. Mr. Chairman, I am pleased that you will be hearing today from Mr. Chuck Hassebrook of the Center of Rural Affairs and Mr. Cal Coulter. The center is located in Walthill, NE. Mr. Hassebrook has been working on agriculture issues for quite some time. Mr. Chairman, I look forward to working with you and members of this committee and our other colleagues in the coming months on reforming our Tax Code and making that tax system fair for those who make their living in agriculture. I would simply say, Mr. Chairman, that as one member of the Senate, I have tremendous confidence in you, Senator Long—the ranking member of this important committee—the former chairman of this committee, Senator Dole, who is now the majority leader of the U.S. Senate, and several other members of this committee whom I think are real experts on this Tax Code problem. I would suggest that since we are talking about the President's proposal here today, that by and large this is a political proposal. I have enough confidence in you to know that you had better take the attitude of junking the President's tax proposal as unworkable. Maybe parts of it could be incorporated into a plan, but I believe the U.S. Senate, at least, would be far more likely to support tax simplification if it were written by this committee, taking parts of the President's plan and maybe some of the other plans that have been offered a long time before the President recognized the need for tax simplification. I believe, though, that trying to work on a plan that carries the President's name, by reforming this bill that you are talking about today, would end up in no tax simplification or reform at all. Therefore, I emphasize once again: I have confidence in you and this committee, and I would hope that, somewhere along the line, you would take the step of saying we are not going to do anything more on the President's tax bill per se. We aren't dictated to act on what the President sends up here, and move forward with a bill that I believe I can support—one that would come out of this committee after due deliberations. Mr. Chairman, I thank you very much for allowing me to jump in at this juncture of the hearing.

The CHAIRMAN. Thank you. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman. I want to commend you for the statement you made regarding the administration's proposals on taxation of timber. I share your views in large part. It is particularly ironic that a proposal that is presented in the name of fairness should so unfairly discriminate against one sector of the economy. As you indicated, Mr. Chairman, if all assests were treated in the same way; if all products were treated in the same way; then, of course, the timber industry would not be in any position to complain. But they are not, and I think that the administration's proposal would have the dual effect of creating a new unfairness and undermining our national effort to improve our situation with respect to the availability of timber resources in the coming decades. My State, Maine, like yours, is based upon a wood economy, a timber resource that is the foundation of our entire State economy. I join with you and hope to work with you in seeing that the product of this committee's deliberations is a system that treats this important resource fairly and in a manner consistent with that which other important resources are treated.

The CHAIRMAN. I thank my distinguished colleague for that support. Now, we will take Mr. Roberts, and I believe, Mr. Frazer, you are going to tesify together. Is that correct? Go right ahead and divide it up as you want, gentlemen.

STATEMENT OF BURNELL ROBERTS, CHAIRMAN, MEAD CORP., DAYTON, OH

Mr. ROBERTS. Thank you. Good morning, Mr. Chairman and members of the committee. I am Burnell Roberts, and I am chairman of the Mead Corp. and senior vice chairman of the Forest Industries Committee on Timber Evaluation and Taxation. I appreciate the opportunity to be here today to represent the committee, which represents a little bit more than 7 million timber owners throughout the country. I have asked Mr. Condrell, as the legal counsel of the committee, to join with us this morning. I would like to first of all thank Senator Packwood and Senator Mitchell for your opening remarks. They summarize mine very well, but I would like to add some other comments for you. In hearings last month, your committee did hear how the capital recovery provisions of the administration's proposal, the repeal of the ITC, the cutbacks in ACRS, the recapture rule—how they would all severely impair our Nation's competitive position in the international marketplace. Forest product companies like Mead which are extremely capital intensive will not only be impacted by those three items, but will also be impacted by the proposals which prevent timber growers from annually expensing their timber management costs, property taxes, interest expense; and then additionally the proposal calls for the repeal of timber capital gains treatment.

Historically, forest products have been one of our Nation's leading exports. Recently, however, because you all know with the strength of the American dollar, our international competitiveness has declined significantly. The administration's proposal will severely impact new investements in timber and in the manufacturing plants and equipment that is needed for the processing of that timber. Therefore, I would expect that our position in the international arena will be further negatively impacted. Domestically, the timber industry will not fare much better. If you look at the chart that we have on my left, entitled "U.S. Consumption and Projected Supply and Demand," the U.S. Forest Service has predicted increasing shortages of timber, independent of any further impact caused by the administration's proposal. These predicted shortages are not all together surprising since, as shown on the next chart—which is entitled "The Return on Equity and Manufacturing"—even with the current tax treatment, our industry's return on equity has been significantly less than other industries. By increasing the tax on the sale of timber and eliminating the annual expenses of timber-related costs, the administration proposal will further reduce our industry's rate of return. The tax proposal also ignores the proven relationships between Federal tax policy and timber supply. Before 1944, our Nation's available timber was declining each year as harvests exceeded new growth. Since that year—which is the year when capital gains treatment for timber was first enacted—our timber resources have increased consistently, as demonstrated by the chart entitled "U.S. Timber Growing Stock." New plantings are also in record amounts as shown in this next and last chart, entitled "Annual Forest Plantings on Private Lands." The proposal to require timber growers to capitalize rather than expense the costs of their timber management expense, property taxes, and interest is especially onerous. This will delay any recovery of those costs until the timber is harvested, which can take place in 20 years, 30 years, 40 years or more after planting. The combined effect of these proposals on virtually all timberowners will be devastating. It might also be well to recognize that the large forest products companies, such as my own—and the large forest products companies own about 13 percent of the commercial timberland in the United States—approximately 70 percent of the timber consumed is produced by the small- and medium-sized tree farmers. In Mead's case, we are dependent on approximately 75 percent of our tree farmers for our wood. Mr. Chairman and members of the committee, I urge you to reject the proposal in the administration's tax package to the extent that they have virtually impacted timber. In this regard, I think it should be remembered that timber is not being regenerated today. That that is not regenerated today will not be available tomorrow when we need it. A mistake in timber tax policy made today will represent a permanent loss in timber supply. This concludes my statement, and we have provided a written statement we would like to have entered into the record. I would like now to turn it over to Mr. Eley Frazer, who is accompanying me, to give you his remarks on behalf of the Forestries Industries Committee on Timber Valuation and Taxation and other cooperating associations.

The CHAIRMAN. Go right ahead, Mr. Frazer.

[The writtem prepared statement of Mr. Roberts follows:]

WRITTEN STATEMENT OF

BURNELL ROBERTS

Chairman of Mead Corporation
and
Senior Vice Chairman of the
Forest Industries Committee on Timber
Valuation and Taxation

and

ELEY C. FRAZER, III
President
F & W Forestry Services, Inc.

on behalf of the

FOREST INDUSTRIES COMMITTEE FOR
TIMBER VALUATION AND TAXATION

and

COOPERATING ASSOCIATIONS

before the

SENATE FINANCE COMMITTEE

July 10, 1985

INTRODUCTION

This statement is presented by the Forest Industries Committee on Timber Valuation and Taxation on behalf of the 7 million timber owners in the United States in support of federal tax policies that are compatible with the economics of intensive regeneration and management of private timber resources. Such policies stimulate the maintenance and creation of jobs and assist in continuing to make forest products one of this nation's principal exports. In addition, for purposes of this testimony we also represent over 60 forest-related associations, including the American Paper Institute, American Plywood Association, Forest Farmers Association, Industrial Forestry Association, National Forest Products Association, and Southern Forest Products Association. A list of the associations is attached as Appendix A.

The Forest Industries Committee's members include timberland owners of all sizes from all timber producing regions of the country -- from small tract owners and forest farmers to the largest of the integrated forest products enterprises. Our industry is easily the least concentrated of the resource-based industries. Approximately 80 percent of the privately-held commercial forest acreage is in the hands of non-industrial owners.

There is unanimity among all sectors of the industry that federal tax policy will determine the quantity of timber that will be available for harvest in future years, as well as

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the extent to which the timber resource will be managed for higher productivity. This in turn directly influences employment in those areas of the country dependent upon a healthy timber industry. Similarly, it affects the extent to which forest products exports can continue to be a major contributor to our nation's balance of payments. As a result, virtually all growers have a stake in the tax policy decisions affecting timber -- in proportion to their contribution to the nation's supply of wood for processing into consumer products.

II. THE CURRENT TAX TREATMENT OF TIMBER AND THE ADMINISTRATION'S PROPOSALS

A. Generally

It is our intention in this statement to address the effects on timber owners and the economy of several specific aspects of the Administration's tax package of May 29, 1985.

The purpose of the package, as stated in the letter transmitting it to Congress, is to "overhaul our tax code based on the principles of simplicity and fairness, opening the way to a generation of growth." Indeed, this sentiment is echoed in the very title to the package -- "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity."

We believe these are laudable objectives, which we support. But for timber growers the proposals are neither simple nor fair. Rather than encouraging growth, the adoption of the Administration's proposals with respect to timber would presage the return to the decline of our nation's timber resource that was taking place prior to 1944.

Before evaluating the specific aspects of the Administration's package that would affect timber owners, we will briefly present a statement of the current tax treatment of timber, followed by a statement of how that treatment is proposed to be changed.

B. Current Tax Treatment of Timber

1. Timber Management Expenses and Carrying Costs

Under current law, the costs paid or incurred in acquiring or creating standing timber are capitalized. Costs of creating standing timber include those for seeds or seedlings, for preparation of the site, and for planting (including tools, labor, and depreciation) and early stand establishment.

Costs paid or incurred for management and protection after the timber is established are deductible currently. Establishment occurs one or two years after the seedlings are planted. Thus, after such time costs for fire, disease, and insect control and maintenance become deductible as paid or incurred.

This treatment -- the capitalization of pre-establishment costs and the current deduction for post-establishment costs -- does not arise from any specific Code provisions.

Rather, it stems from the application to timber growers of Code provisions generally applicable to all taxpayers.

In addition, interest and property taxes paid or incurred are deductible currently by timber growers regardless of the time of establishment in accordance with Code Sections 163 and 164 which are applicable to all taxpayers.

2. Capital Gain Treatment

Under current law, most timber income is taxable at long-term capital gain rates. Capital gain rates apply to timber as a result of either the general provisions of Internal Revenue Code ("Code") Sections 1221 and 1231 applicable to all taxpayers or the specific provisions of Section 631(a) and (b) applicable only to timber owners.

Under the general provisions of Sections 1221 and 1231, a timber owner who makes an outright sale of his standing timber may potentially receive capital gain treatment. Section 1221 applies to a timber owner who holds his timber for investment; Section 1231 applies to a timber owner who holds his timber for use in his trade or business.1/

1/ I.R.C. § 1231 applies to real property used in a trade or business. In most instances, standing timber will constitute real property for purposes of that section.

If I.R.C. § 1231 is applicable, the availability of capital gain treatment will depend upon the aggregation of all gain and loss subject to I.R.C. § 1231 for the taxable year. Where the aggregation is a net gain, each item will be treated as capital gain or capital loss; where the aggregation is a net loss, each item will be treated as ordinary income or ordinary loss.

Under the specific provisions of Section 631(a), a timber owner who cuts his timber for sale or use in his business may also receive capital gain treatment. Similarly, capital gain treatment may be available under the specific provisions of Section 631(b) to a timber owner who disposes of his timber under a contract retaining an economic interest.2/

Under both the general and specific rules, if the statutory holding period is satisfied, the excess of the timber's sale price (the fair market value in the case of timber cut by its owner pursuant to Section 631(a)) over its tax cost is the gain that is taxable at the long-term capital gain rate. Any value added subsequent to the harvest (e.g., from processing the timber into paper, lumber, etc.) is taxable at ordinary income rates.

In the case of taxpayers other than corporations, present tax law provides that 40 percent of the long-term capital gain is taxable, with the tax computed at ordinary income tax rates. Thus, a taxpayer subject to tax on ordinary income at the maximum marginal rate of 50 percent will be subject to tax on long-term capital gain at a maximum rate of 20 percent (i.e., 40% x 50% = 20%).

In the case of corporations, present law provides that the long-term capital gain is, as a general matter,

2/ I.R.C. § 631(a) and (b) do not grant capital gain treatment *per se*. Rather, those provisions provide that any gain or loss to which they apply will be treated as gain or loss under Section 1231. *See* I.R.C. § 1231(b)(2). *See also supra* note 1.

taxable at 28 percent. This rate compares with the generally applicable rate of 46 percent on ordinary corporate income.

3. Reforestation Incentives

Under current law, up to $10,000 of reforestation expenses annually is eligible for amortization deductions over 84 months and for a 10 percent investment tax credit. This provision is uniquely focused on encouraging small landowners to regenerate their timber holdings.

C. Administration's Proposal

1. Timber Management Expenses, Property Taxes, and Interest

The Administration's proposal would require the capitalization of timber management expenses, property taxes, and interest paid or incurred during the entire time in which the timber is standing prior to cutting. To the extent that these costs would be capitalized, they would be indexed for inflation.

The effective date of the required capitalization would depend upon when the timber was planted. To the extent that such costs are incurred with respect to timber planted after January 1, 1986, all timber management expenses, property taxes, and interest would have to be capitalized. To the extent that such costs are incurred with respect to timber that was planted before 1986 (and are deductible under present law), their deductibility would be phased out at the rate of ten percent per year for ten years. Thus, in 1986, 90 percent of such costs would be deductible and 10 percent would be capitalized; in 1987, 80 percent would be deductible and 20 percent would be capitalized; and so forth until 1995 when the current deduction would be totally eliminated and all such costs would have to be capitalized.

Generally, the interest that must be capitalized will be that interest attributable to indebtedness incurred on account of timber growing. However, the proposal does not provide for a straightforward determination of indebtedness incurred on account of timber growing, but instead provides a complex ordering rule to be used in making this determination.

Under the ordering rule, any indebtedness, regardless of the purpose for which it is incurred, will be deemed attributable to the cumulative capitalization of timber management expenses, property taxes, and interest. In other words, any borrowings made by the timber grower for other purposes will be deemed to have been made to finance the cumulative capitalized amounts of timber management expenses, taxes, and interest. As a result, the proposal requires the capitalization of interest paid on account of the amount of indebtedness deemed to have been incurred to finance timber growing.

2. Capital Gain Treatment

Although the Administration's proposal would retain capital gain treatment for some taxpayers and would lower the maximum noncorporate capital gains tax rate to 17 1/2 percent by lowering the maximum ordinary income rate to 35 percent and by reducing the capital gains deduction to 50 percent -- it would repeal the specific timber capital gain provisions of Section 631 and 1231. As a result, timber cut by its owner, timber sold pursuant to a cutting contract, or, if held for use in the taxpayer's trade or business, timber sold outright in a lump sum sale would be taxed at ordinary income tax rates. Under the proposal, these would be as much as 35 percent for noncorporate taxpayers and 33 percent for corporate taxpayers. Thus, non-corporate taxpayers now subject to a tax of 20 percent on their historic timber appreciation would be subject to a tax of 35 percent; corporations now subject to tax of 28 percent on their historic timber appreciation would be subject to a tax of 33 percent.

This proposal would be fully effective January 1, 1989, for timber cut by its owner or sold pursuant to a cutting contract. However, beginning January 1, 1986, capital gain treatment in such cases would be phased out. Individuals, who under current law are permitted to deduct 60 percent of their capital gains would, in 1986, be permitted to deduct merely 30 percent of their timber capital gains. The deduction would decline to 20 percent in 1987, and to 10 percent in 1988. For corporations, the alternative capital gains tax rate would be 30 percent in 1986, and would increase by 1 percentage point in each of 1987 and 1988. In addition, income from the outright sale of timber that was placed in service after January 1, 1986, and that was held for use in a taxpayer's trade or business would be taxable at ordinary rates.

Finally, the proposal provides that, in all cases except those where timber is considered a capital asset, the taxpayer's basis in his timber would be indexed to provide for inflation. However, in those cases where capital gain treatment is to be phased-out, no indexing is provided during the phase-out period.

3. Reforestation Incentives

In addition, effective January 1, 1986, the proposal eliminates the amortization and tax credit under current law whereby up to $10,000 of reforestation expenses annually is eligible for amortization deductions over 84 months and a 10 percent investment tax credit.

III. THE ADMINISTRATION'S PROPOSAL DOES NOT STIMULATE GROWTH

A. Timber Supply Has Responded to Federal Tax Policy

1. Generally

In considering the effect of the Administration's proposal on economic growth, it is important to bear in mind that there is probably no more dramatic example of the direct relationship between tax policy and producer response than is evident in the history of the timber economy throughout the 20th century.

2. <u>Pre-1944</u>

During the period up to the early 1940's, the nation's timber resource was in a state of alarming decline. For the most part, timber operations were conducted in a manner similar to mining or petroleum production -- the emphasis was on extraction. In the case of timber, however, this need not have been the case: The harvested timber resource could have been regenerated -- either by natural means or by careful management to accelerate the reforestation and growth processes. Unfortunately, the federal income tax policies then in effect weighed heavily against such action.

Prior to 1944, timber was recognized as a capital asset -- along with land and improvements for farm or business use, commercial properties and equity interest in other enterprises -- but only if the timber was sold by the owner in a lump-sum transaction. If, on the other hand, the owner chose to manage the resource on a sustained yield basis -- if he replanted or managed it as an ongoing investment through selective or periodic harvests -- the owner was denied capital gain treatment. Also, if the owner harvested timber for processing in his own plant, he was denied capital gain treatment. In other words, conducting sustained yield timber operations -- which in some areas required up to 50 years or more to complete a marketing cycle -- was viewed for tax purposes to be the same as planting a crop in the Spring and harvesting it in the Fall.

Thus, the tax laws of the time fostered a continuation of economically wasteful and counter-productive practices. In effect, they imposed a severe tax penalty on those who wished to manage their lands wisely. As a consequence, there was indiscriminate cutting; soil and watershed values were lost; vast acreages were abandoned for taxes because the owners could not afford to do anything with them; and far too much timberland was converted to marginal farm production -- with sorrowful consequences for both the land and the operators.

3. The 1944 Amendments Stimulated Timber Supply

In 1944 Congress eliminated this major disincentive to sustained yield private forestry. By extending capital gain treatment to the disposition of timber with a retained economic interest and to the harvest of timber assets for manufacture in a mill operated by the timber owner, Congress declared it to be in the public interest to stimulate capital reinvestment and improved management of timberlands.

The response of timberland owners must have suprised even the most optimistic advocate of tax reform. Up until 1944, the inventory of growing stock on private forestlands was declining by 7 billion cubic feet per year. This trend was dramatically reversed following Congress' action, demonstrating that landowners were philosophically committed to proper managment of their lands but previously had not been able to justify it economically.

In the more than 40 years since adoption of what are now Sections 631(a) and 631(b) of the Internal Revenue Code, the nation's inventory of standing timber has increased by more than 195 billion cubic feet. See Appendix B. Planting of seedlings -- which was almost nonexistent prior to 1944 -- is now in the hundreds of millions each year. See Appendix C. On some of the better managed lands, 9 or more seedlings are planted for each mature tree harvested.

In the years immediately preceding 1944, government and private experts were predicting a "timber famine" by the 1960s and 1970s. And, the predictions were based on what have since proved to be substantial underestimates of consumer demands for wood products. But, despite those unexpected demands, the timber growers of the country have not only kept pace with the needs of our economy, they have actually grown more each year than is harvested. The current proposals, however, would result in pressures on the forest that would adversely modify this outstanding achievement.

4. The Administration's Proposal Would Bring Back the Pre-1944 Discrimination

Enactment of the Administration's recommendation to repeal timber capital gain treatment would effectively bring back the strong disincentives for sustained yield forestry that existed prior to 1944: Income from bulk sales of investment timber could be taxable at capital gains rates, but income from managed forests would be taxable at ordinary income rates.

Indeed, with the adoption of the concomitant recommendation to require the capitalization of timber management expenses and carrying costs, the overall effect of the Administration's package would add obstacles to proper management beyond those that existed prior to 1944: To replant or to allow natural regeneration after harvest would require the owner to capitalize the management and carrying costs in connection with such lands for an entire growing cycle. As a result, this would further encourage the conversion of their lands to other uses.

In view of our nation's estimated future timber needs, the Administration's proposal does not promote economic growth. Rather, it would assure the scarcity of a critically need resource.

B. Our Nation's Future Timber Needs Are Increasing

1. Our Estimated Future Timber Needs Continue to Be Great

The United States Forest Service estimates that domestic demand for paper and wood products may double by the year 2030 with the demand for paper and wood products climbing from 13.4 billion cubic feet in 1976 to 28.3 billion cubic feet in 2030. See Appendix D. Table I summarizes the projected supply/demand situation:

Table I

Summary of U.S. Supply and Demand for Timber in 1976 and 2030 3/

Category	Billion Cubic Feet 1976	2030
Total U.S. demand	13.4	28.3
Exports	1.8	1.3
Imports	2.8	4.5
Demand on U.S. forests	12.4	25.1
Supply from U.S. forests	12.4	21.2
Supply/demand in balance	0.0	-3.9

2. The Administration's Proposal Would Exacerbate Predicted Supply Shortages

It is not unreasonable to expect that, without considering the effect of the significant price distortions that would be certain to result, the proposal as a whole would cause a future loss of timber sufficient to build 400,000 houses per year or 2,000,000 housing units during the period of the Treasury forecast. Stating it another way, the proposal could trigger an increase in harvest pressure on public and private lands equivalent to approximately 300,000 acres annually -- an area about one-half the size of the Yosemite National Park.

3/ In part because of the hazards of making estimates of what is likely to occur fifty years hence, the United States Forest Service ("USFS") has considered three alternative economic and demographic scenarios for its estimates. Based on these scenarios, the USFS has developed three alternative possible future demand levels -- low-level demand, medium-level demand, and high-level demand. The data presented in this testimony depicts the results that will ensue assuming that medium-level demand were to occur.

To meet the nation's future forest product needs, reforestation <u>must</u> continue at high levels. Unlike mistakes in other areas of tax policy that can be corrected without long-term effects, an adverse change in timber tax policy will directly result in lost tree growth -- a loss which is irreversible even with modern forestry technology. A tree not planted is wood supply forever lost. Intensification of future planting efforts simply will not replace the lost timber volume with the time frame in which it will be needed.

We need only look to our own history which clearly shows that before timber capital gains taxation was adopted, entire regions of the country were cut -- decimated. And the Administration's proposals to repeal capital gain treatment for timber and to require the capitalization of timber management expenses, property taxes, and interest would lead us again in that direction -- an experience not unlike that which occurred in other countries when they have ignored the special requirements of long-term growing.

C. Forest Products Are Important to International Trade and Our Balance of Payments

Forest products are one of our nation's most important exports. Indeed, until recently, they represented our nation's second greatest source of exports, with only agriculture accounting for a greater share.

Significantly, a major portion of these exports are being made to countries with which we need to increase our balance of payments -- Japan, Canada, and the EC countries. Other important export markets include South Korea, Taiwan and China.

In the last several years, however, the forest products industry has lost market share overseas on account of United States policies that have caused the dollar to rise relative to other currencies, high trade deficits, and high real interest rates. And even without the disadvantages that would result from the Administration's tax proposal, the United States Forest Service estimates that exports of timber will fall from 1.8 billion cubic feet in 1976 to 1.3 billion cubic feet in 2030.

Moreover, at the same time that exports are projected to be declining, imports are estimated to be rising -- from 2.8 billion cubic feet in 1976 to 4.5 billion cubic feet in 2030. The current tax proposal is an example of yet another United States policy that would disadvantage our industry at home and in the international market place.

Repeal of timber capital gain treatment and imposition of the requirement to capitalize timber management expenses and carrying costs will further impede our ability to compete internationally, rather than ~~tapping the~~ potential to improve our balance of payments. Indeed, with the other provisions of the proposal that would repeal the investment tax credit, replace ACRS with a slower depreciation system, and recapture past ACRS deductions, the proposal as a whole ensures the timber industry's impotence in international competition.

IV. THE ADMINISTRATION'S PROPOSAL DOES NOT PROMOTE FAIRNESS AND EQUITY

A. Generally

The Administration's proposal fails to recognize the risk characteristic of the long-term investment required for timber. This risk, however, is well understood in the marketplace and results in difficulties in attracting the needed capital investment. This will be considered in detail below.

Moreover, the proposal is unfair to the hundreds of thousands of workers whose jobs depend upon the timber industry. To the extent that the timber industry will be adversely affected by the proposal -- and indeed it will if the proposal were to become law -- dozens of rural communities will be devastated as timber operations in those communities are curtailed.

Finally, apart from such difficulties, the President's proposal is unfair to the hundreds of thousands of timber owners who have planted and maintained their forests in anticipation of fair tax treatment on harvest. These timber owners have reasonably based their investment decisions on continuation of a tax policy that has been the existing law for more than 40 years.

B. Difficulties in Attracting Capital

The abundance of our forest resources is a strength enjoyed by few other nations. Yet the commitment of major amounts of capital over unusually long periods of time is required to develop, maintain, and utilize that resource in the most efficient way. It has been estimated that $15 billion or more is required for new investment if we are to meet projected market requirements.

A principal deterrent to attracting capital is the historically low rate of return on timber investments. Census Bureau and Federal Trade Commission reports indicate the return on equity for paper and allied products for the period 1977-1984 was almost 20 percent less than the return for non-durable goods and almost 15 percent less than the return for manufacturers of all goods. See Appendix E.

The problem of low rate of return is compounded by the illiquidity of the timber investment and the long period in which the investor must wait before his investment in his forest can be recovered. In the West, no portion of the capital invested may be recouped for 30 years, with the recovery of the investment being made thereafter over the harvest cycle -- a total of 50 years or more. In the South, no investment may be recouped for 13 or more years, with the recovery of the investment taking place thereafter over the harvest cycle -- a total of 25 years or more. But regardless of where the timber is growing, the forest investor must make cash outflows annually for period costs to maintain and protect his property. These costs include payments on account of annual property taxes, fire, insect and disease prevention, and other timber management expenses.

Moreover, the risks involved in timber management are unusually high. The investor faces the threat of possible loss of assets through fire or other hazard. In the case of fire, the timber resource can be totally destroyed -- with little, if any, salvage value to the owner. In the case of wind, ice, disease, or other casualties, the value of the asset can be greatly diminished, and its capacity for production can be seriously impaired for many years.

It is significant that casualty loss insurance is simply not available on standing timber at feasible rates. This is a reflection of the magnitude of the risks undertaken by those who launch a timber growth enterprise.

And then there is the final risk. After making the initial investment decades earlier and after meeting the burden of annual management costs year after year, the landowner finally sees the timber attain harvest size. He is then subject to the vagaries of the market -- a market that is notoriously sensitive to declines in the home building industry, and that due to the high value of the dollar, has been wracked by low-priced imports.

So the combination of low predicted rates of return, high carrying costs and the natural and economic risks involved in timber growing will make it extremely difficult to attract the level of capital investment required to make the nation's timberlands sufficiently productive to ward off anticipated shortages.

These are the handicaps which must be addressed by our nation's policy makers if we are to anticipate and prepare adequately for the timber supply needs of the United States by the year 2030 and beyond -- because we cannot wait until the shortage is upon us to take remedial action. We will never find a way to grow a tree in that short a time. However, rather than addressing these inherent handicaps, the Administration's proposal unfairly adds to them, thus making it even more difficult to attract the necessary investment.

If we are to keep capital flowing to timber so that the investment required to meet our future needs will be made, we must maintain, if not improve, the desirability of timber investments relative to other investments. This requires preserving the tax rate differential on gain from timber relative to gain from other investments. Presently, for non-corporate timber owners, the maximum tax rate is 20 percent, a 60 percent reduction from the maximum tax rate of 50 percent on ordinary income. Similarly, for corporate timber owners, the maximum tax rate is 28 percent, roughly a 40 percent reduction from the 46 percent tax rate on ordinary income. Accordingly, if the rates on ordinary income are reduced, roughly the same relationship must be maintained between the tax rate on gain from timber and the tax rate on gain from other income -- a 40 percent to 60 percent rate differential. If a differential at least this great is not maintained, investment will be diverted from timber to other areas.

C. The Continued Deductibility of Timber Management Expenses and Carrying Charges Is Fair

1. Generally

Owners of timber are, as stated above, currently subject to the same rules on the deductibility of their timber management expenses, taxes, and interest as are all taxpayers. The Administration's proposal, however, would change this to apply special rules to timber owners that would require them to capitalize these costs. In other words, although timber owners would pay such expenses regularly, they would receive no tax benefit on account of these expenses until the harvest of the timber with respect to which they are incurred -- 20, 30, 40, or even 70 years later. This approach is inconsistent with generally accepted accounting standards and misconstrues the nature of these expenses.

2. The Deductibility Comports With Generally Accepted Accounting Standards

Under generally accepted accounting standards, timber owners treat their timber management expenses, taxes, and interest as period expenses. Thus, the current tax treatment of these items is the same as that used for financial reporting purposes.

This treatment, which is approved by the accounting profession, most fairly depicts financial income: Indeed, the treatment of these items as period expenses <u>reduces</u> reported annual corporate earnings (which would be higher were such amounts capitalized).

3. The Proposal Misconstrues Timber Management Expenses

Under current law, timber owners are already required to capitalize those expenses incurred to acquire, create, or establish timber. This is precisely the same treatment provided under current law -- and under the proposal -- for owners of other assets for their costs of acquisition, creation, or establishment. There is no basis for subjecting timber owners to different rules.

The proposal appears premised on the mistaken notion that the ability to deduct expenses currently provides timber owners with an inappropriate advantage. Rather, the current deductibility of these items is in accord with the general rules provided by our tax laws -- rules that as a general matter would not be amended by the proposal.

The Code provides as a general rule that expenditures for the maintenance of an asset are permitted to be expensed.[4/] Maintenance expenses are deductible annually if they are ordinary and necessary expenses either incurred in a trade or business or incurred for the management, conservation or maintenance of property held for the production of income.[5/] Apart

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4/ I.R.C. §§ 162(a), 212.

5/ I.R.C. §§ 162(a), 212(2).

from this general rule, the Code specifically entitles all taxpayers to deduct currently their interest expenses[6/] and property taxes.[7/] These are the rules applicable to all taxpayers. That current law provides timber owners with this treatment does not stem from any timber-oriented provision of the Code.

Moreover, maintenance costs, taxes, and interest are current expenses which if not paid could result in the total loss or diminution in value of the underlying asset. Clearly, they must be paid to maintain such asset, and it would thus be inappropriate to capitalize such costs.

Also, the application of these principles does not require the matching of items of income and expense under any theoretical notion. Under current law, and under the Administration's proposal, owners of any asset not earning current income are permitted to expense the cost of maintaining their asset. For example, the costs of maintaining idled factory buildings and warehouses or unproductive land may all be expensed. Similarly, the owner of a vacant rental property is able to deduct maintenance expenses incurred for that vacant property against other income. And the owner of a growth stock

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6/ I.R.C. § 163(a).

7/ I.R.C. § 164(a)(1)-(2). For a limited exception to this rule, see I.R.C. § 189 (requiring the capitalization and amortization of interest and taxes for real property during its construction period).

portfolio yielding no annual income may annually deduct custodial fees from his other income, despite the fact that no dividends are received from his portfolio. In a like vein, a timber owner is permitted to deduct the annual costs of disease and fire control and similar expenses, despite the fact that the trees remain unharvested.

It is also important to note that a timber owner often possesses more than the right to harvest the trees on his land: Timber ownership may confer the rights to all uses of the property. For timberland, these uses often include hunting, farming, grazing, mining, and watering rights; additionally, certain trees on the property may yield turpentine or maple syrup. Where the timberland owner uses or rents his property for any of these uses, such uses benefit from many of the maintenance expenses incurred with respect to the property. For example, interest expenses, property taxes, fire control expenses, etc., benefit all uses of the property. This is significant because each of these other uses often produces income currently. To such extent, the timing of income and expenses coincides.

In sum, the Administration's proposal would discriminate against timber owners by subjecting them to special rules that would postpone their deductions for timber management expenses, taxes, and interest. There is simply no justification for ceasing to apply to timber owners the generally applicable rules that would permit such expenses to be deducted as paid or incurred.

4. The Proposed Interest Capitalization Rules Are Uniquely Unfair to Timber Growers

The proposal, as a general matter, requires interest paid on indebtedness attributable to timber growing to be capitalized. However, as a result of its ordering rule, the proposal requires interest to be capitalized even where there is no indebtedness owing on account of timber growing: So long as a timber grower has any indebtedness outstanding, that indebtedness will be considered to have been incurred with respect to timber growing to the extent of the taxpayer's cumulative capitalized amounts of timber management expenses, taxes, and interest.

The ordering rule is uniquely unfair to those timber growers who use borrowed funds to finance business activities and investments other than timber growing. For example, consider a taxpayer owning a timber stand outright who borrows funds to buy an apartment building. That taxpayer would be required to capitalize the interest on such borrowing to the extent such borrowing does not exceed the timber owner's accumulated capitalized amounts of timber management expenses, taxes, and interest. Thus, the timber grower owning the apartment building would be taxed less favorably than a non-timber-growing similarly situated taxpayer owning the same apartment building. Moreover, the ordering rule would inhibit an integrated timber company's replacement or expansion of its manufacturing facilities, costs which are frequently financed with borrowed funds.

Also, the interest capitalization rules discriminate against the long-term holding of timber stands. The longer a timber grower owns his stand, the greater the penalty under the proposal: The cumulative capitalized timber management expenses, taxes, and interest will increase each year prior to harvest, as a result of which, an increasing portion of such timber grower's other borrowings would be deemed used to finance his timber growing. Thus, the owner-debtor of a timber stand who has held it throughout its growing cycle would have to capitalize more interest than an owner-debtor of a identical timber stand who had recently purchased it.

V. THE ADMINISTRATION'S PROPOSAL DOES NOT PROMOTE SIMPLICITY

The Administration's proposal does not promote simplicity. Rather, if adopted, the proposal would require taxpayers to maintain for the entire timber growing cycle records of their expenditures on account of timber management expenses and carrying costs. While it can be argued that these records will not be a burden for the major companies which are accustomed to this type of recordkeeping, the many smaller, individual timber owners, will find these new requirements to be onerous.

The proposal would require the timber grower to determine annually his timber management expenses, property taxes, and interest; he would have to record these items annually; he would have to accumulate them annually with previously incurred timber management expenses, taxes, and interest; and he would have to index them annually. Also, if the timber owner had borrowings unrelated to his timber growing, he would have to determine the extent to which such borrowings were attributable or would be deemed attributable to timber growing, compute the interest allocable to such amounts, and record, accumulate, and index such interest as if actually incurred with respect to timber growing.

In considering just how onerous these requirements are, it should be kept in mind that some small timber owners cannot determine the basis of timber that they purchased decades previously. Yet the proposal would require these annual machinations to be made for as long as the timber is standing -- a period that in some parts of the country can span upwards of 50 years.

VI. MISPERCEPTIONS ABOUT THE EFFECT OF THE PROPOSAL ON THE FOREST PRODUCTS INDUSTRY

A. The Effective Tax Rate of the Forest Products Industry Is High But for the 1980-83 Recession

Although for the reasons stated above it seems clear that the proposal achieves none of its goals insofar as timber growers are concerned, timber growers may have been singled out for adverse tax treatment in the mistaken belief that they are not paying their fair share of taxes. This misimpression may have been fostered by a survey on effective tax rates undertaken for the past several years by the staff of the Joint Committee on Taxation ("JCT") -- the so-called Pease-Dorgan study.

For several of the years considered, five forest products companies surveyed were reported to have low current effective tax rates. The low effective tax rates for these years, however, are not due to any special advantage received by the timber industry. Rather, they are explained by the combined effect of the depressed timber market during the survey years coupled with substantial new investment in plant and equipment coming on line during the same period.

During most of the years surveyed, 1980 to 1983 the industry's effective tax rates are disproportionately affected by the accelerated depreciation deductions and investment tax credit generated by this new investment. Indeed, the combined effect of the investment tax credit and accelerated depreciation deductions claimed by the surveyed companies was found by the JCT staff to be responsible for reducing the effective tax rate of those companies twice as much as capital gains.[8/]

In this regard, it should be emphasized that timber capital gain treatment is not the cause for the low effective tax rate during the recessionary period: If all income were taxed at capital gain rates, the tax rate could not be less

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8/ Staff of the Jt. Comm. on Tax., Study of 1983 Effective Tax Rates of Selected Large U.S. Corporations 7 (Nov. 28, 1984).

than 28 percent. (It also should be noted that the ability to deduct timber management expenses and carrying costs does not result in a decrease in effective tax rate since such provisions conform to financial statement accounting).

In a typical year both before and after the recession, the industry's effective Pease-Dorgan tax rate has been roughly 25 percent. This rate is comparable to the effective tax rate for most other industries.

B. There Is No Evidence That Timber Is One of the Most Tax Favored Industries

The Treasury Department has said that timber is one of the most "tax favored" of all industries.

The Treasury has not provided any data supporting this statement, and so far as we know there is no data comparing timber with other industries.

The only support that the Treasury Department offers for this statement is an analysis that classifies expensing of timber management costs as a special benefit which it combines with timber capital gain treatment. The study indicates that approximately one-half of the claimed special benefit is due to the expensing treatment, and the other half of the claimed special benefit is due to timber capital gains treatment. Arthur Andersen & Co. has confirmed that the claimed special benefits are allocated in this fashion.

However, as we discuss above, the rules allowing the expensing of timber management costs are not a special benefit.

Indeed, they are considered by the accounting profession to properly reflect income from timber.

Accordingly, timber capital gain treatment is the only arguable special benefit available to timber owners. The claimed special benefit attributable to the expensing rules is in fact not a special benefit. However, timber capital gain treatment represents only one-half of the total of Treasury's claimed special benefit. These benefits, which result in a tax rate of 28% for corporations and a maximum tax rate of 20% for individuals, does not make timber one of the most "tax favored" of all industries.

C. All Timber Owners Benefit Proportionally to Their Timber Investment

Sometimes it has been said that most of the benefits from timber capital gain treatment accrue to the major companies. This is simply not true. Each timber owner benefits from capital gains proportionally to his holdings. In this connection, the forest products industry owns 68.8 million acres of timberland, while other private owners own 278 million acres -- almost four times as much.

D. The Revenue Gain to the Treasury From the Proposal Is Minor

The repeal of the specific timber capital gain provisions will, by the Administration's own estimate, yield relatively little to the Treasury. The tables accompanying the

Administration's proposal show that the effect on an individual's income taxes each year from 1986 to 1990 will, to use its own term, result in a "negligible" increase in revenues. The increase in corporate income taxes, however, is predicted to rise from "negligible" in 1986, to $100 million in 1987 and in 1988, and to $200 million in 1989 and 1990. These revenue estimates are from one-third to one-quarter of previous projections due primarily to revised and improved numbers issued by the Treasury Department.

The tables accompanying the Administration's proposal do not separately state the anticipated effect on revenues from the proposed capitalization of timber management expenses and carrying costs. Nevertheless, as in the case of timber capital gains revenue, their importance to timber owners substantially outweighs the anticipated insignificance relative to the other revenues being adjusted in the proposal.

VII. RECOMMENDATIONS

As is evident from the foregoing, the Administration's proposal accomplishes none of its stated objectives with respect to timber owners. The Forest Industries Committee on Timber Valuation and Taxation, after thorough consideration of the tax package, urges the Congress to make several changes that we believe are fully consistent with the Administration's intentions and with the acknowledged need to stimulate new investment in timber growing.

1. We recommend the continuation of the existing differential for timber capital gains provided by Section 631(a) and (b). To the extent Section 1231 applies to timber, it too should be continued. If the maximum individual rate is reduced to 35 percent and the corporate rate is reduced to 33 percent, the maximum rate on any taxpayer's timber capital gains should not exceed one-half of the applicable ordinary rate. This compares to the existing differential of three-fifths for individuals and a slightly lesser amount for corporations.

2. We recommend that fairness should be achieved by reducing the alternative corporate capital gains rate to the maximum non-corporate capital gains rate. This would enable timber owners to select the form of business for the conduct of their operations without regard to artificial constraints imposed by the tax system.

3. We recommend that the present treatment of timber management expenses and carrying costs be continued. This would provide timber owners with the same treatment as the owners of other assets.

4. We recommend the retention of the present incentives for reforestation, which benefit primarily the small landowner.

APPENDIX A

FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION

COOPERATING ASSOCIATIONS

JOHN McMILLAN
Alabama Forestry Association
Montgomery, Alabama

DONALD A. BELL
Alaska Loggers Association, Inc.
Ketchikan, Alaska

LAURENCE WISEMAN
American Forest Institute
Washington, D. C.

RUSSELL P. WIBBENS
American Institute of Timber Construction
Englewood, Colorado

LOUIS F. LAUN
American Paper Institute
New York, New York

BRONSON J. LEWIS
American Plywood Association
Tacoma, Washington

K. S. ROLSTON, JR.
American Pulpwood Association
Washington, D. C.

JAMES L. GUNDY
Appalachian Hardwood Manufacturers, Inc.
High Point, North Carolina

B. J. PAVLOVICH
Arkansas Forestry Association
Little Rock, Arkansas

JANICE L. BISHOP
Associated Cooperage Industries of America, Inc.
Louisville, Kentucky

IVAN CONGLETON
Associated Oregon Industries
Salem, Oregon

ARTHUR F. ENNIS
Association of Consulting Foresters
Bethesda, Maryland

STEPHEN L. DeMARIA
California Forest Protective Association
Sacramento, California

JAKE SPIVEY
Eastern North Carolina Lumber Manufacturers Association, Inc.
Rocky Mount, North Carolina

LARRY FRYE
Fine Hardwoods-American Walnut Association
Indianapolis, Indiana

WILLIAM CARROLL LAMB
Florida Forestry Association
Tallahassee, Florida

B. JACK WARREN
Forest Farmers Association
Atlanta, Georgia

THOMAS KERR
Forest Landowners of California
Sacramento, California

H. GLENN ANTHONY
Georgia Forestry Association, Inc.
Atlanta, Georgia

STEVEN V. LOSSER
National Dimension Manufacturers Association
Marietta, Georgia

CLARK E. McDONALD
Hardwood Plywood Manufacturers Association
Reston, Virginia

N. E. BJORKLUND
Industrial Forestry Association
Portland, Oregon

TOM CHESNEY
Kentucky Forest Industries Assn.
Monticello, Kentucky

CHARLES A. VANDERSTEEN
Louisiana Forestry Association
Alexandria, Louisiana

JOHN R. BUSH
Lumber Manufacturers Association of Virginia
Sandston, Virginia

ROBERT T. CHAFFEE
Maine Forest Products Council
Augusta, Maine

ROBLEY NASH
Maine Hardwood Association
Augusta, Maine

SAMUEL H. DYKE
Maryland Forest Association, Inc.
Salisbury, Maryland

SUE SWORDEN
Michigan Forest Association
Midland, Michigan

JOHN CALKINS
Michigan Forest Products Council
East Lansing, Michigan

CARL THEILER
Michigan-Wisconsin Timber Producers Association
Tomahawk, Wisconsin

M. R. ALLEN
Minnesota Timber Producers Assn.
Duluth, Minnesota

ROBERT IZLAR
Mississippi Forestry Association
Jackson, Mississippi

GERALD E. ROSS
Missouri Forest Products Assn.
Jefferson City, Missouri

DONALD McNEIL
National Christmas Tree Assn.
Milwaukee, Wisconsin

DAVID E. STAHL
National Forest Products Assn.
Washington, D. C.

S. CARROLL WHITE
National Hardwood Lumber Assn.
Memphis, Tennessee

GEORGE E. KELLY
National Lumber Exporters Assn.
Memphis, Tennessee

GEORGE E. KELLY
National Oak Flooring Manufacturers Association
Memphis, Tennessee

WILLIAM H. McCREDIE
National Particleboard Assn.
Silver Spring, Maryland

CHARLES A. LEVESQUE
New Hampshire Timberland Owners' Association
Concord, New Hampshire

RONALD J. SHEAY
New Jersey Forestry Association
Trenton, New Jersey

HOWARD O. WARD
New York Forest Owners Assn.
Candor, New York

BEN F. PARK
North Carolina Forestry Assn.
Raleigh, North Carolina

JOSEPH HINSON
North Idaho Forestry Assn., Inc.
Coeur D'Alene, Idaho

H. KEITH JUDKINS
Northeastern Lumber Manufacturers Association, Inc.
Falmouth, Maine

THOMAS P. BROGAN
Northern Hardwood and Pine Manufacturers Assn., Inc.
Green Bay, Wisconsin

LINDA DeBLOOM
Ohio Forestry Association, Inc.
Columbus, Ohio

DALE CAMPBELL
Oklahoma Forestry Association
Broken Bow, Oklahoma

DAVID R. JESSUP
Oregon Forest Protection Assn.
Salem, Oregon

WILLIAM J. CARY, JR.
Pacific Logging Congress
Portland, Oregon

PAUL BOFINGER
Society for the Protection of New Hampshire Forests
Concord, New Hampshire

ROBERT R. SCOTT
South Carolina Forestry Assn.
Columbia, South Carolina

GEORGE E. KELLY
Southern Cypress Manufacturers Association
Memphis, Tennessee

WILLIAM R. GANSER, JR.
Southern Forest Products Assn.
New Orleans, Louisiana

GEORGE E. KELLY
Southern Hardwood Lumber Manufacturers Association
Memphis, Tennessee

JOHN L. SMITH
Southern Oregon Timber Industries Association
Medford, Oregon

JAMES J. COX, JR.
Southwest Pine Association
Phoenix, Arizona

TIM WHELAN
Tennessee Forestry Association
Nashville, Tennessee

RON HUFFORD
Texas Forestry Association
Lufkin, Texas

CHARLES F. FINLEY, JR.
Virginia Forestry Association
Richmond, Virginia

ROBERT M. MERKEL
Washington Farm Forestry Assn.
Raymond, Washington

STEWART BLEDSOE
Washington Forest Protection Association
Olympia, Washington

JOSEPH W. McCRACKEN
Western Forest Industries Assn.
Portland, Oregon

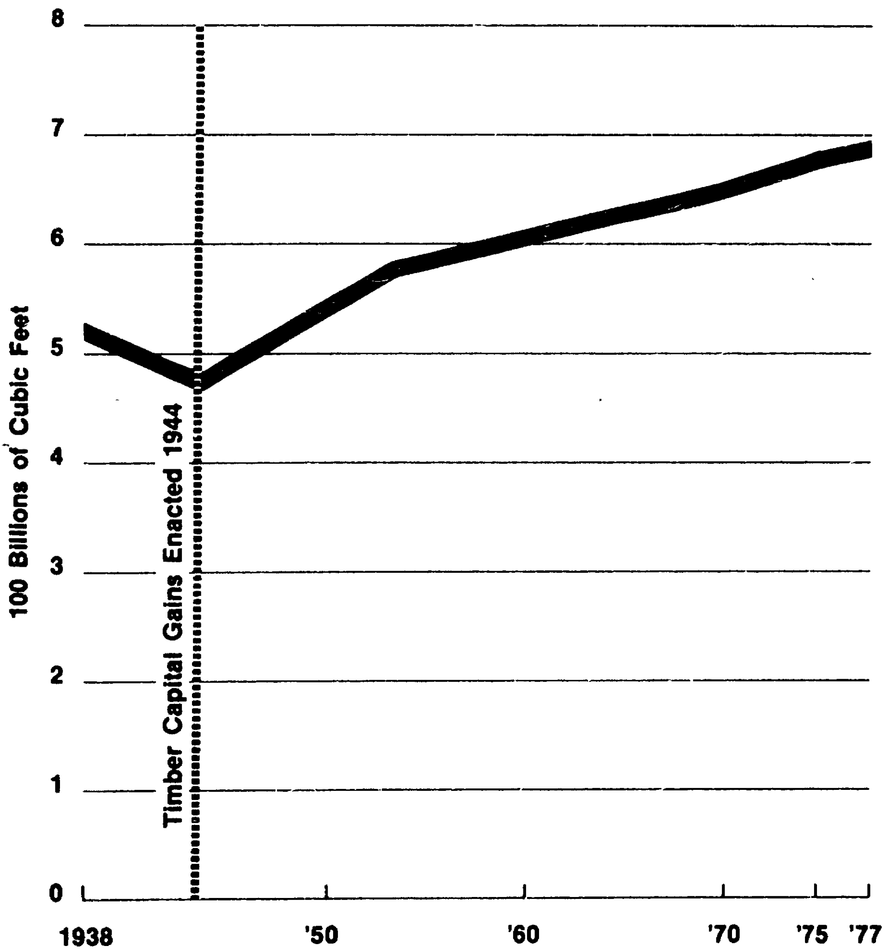
ROBERT TOKARCZYK
Western Forestry and Conservation Association
Portland, Oregon

WILLIAM N. DENNISON
Western Timber Association
San Francisco, California

H. A. ROBERTS
Western Wood Products Association
Portland, Oregon

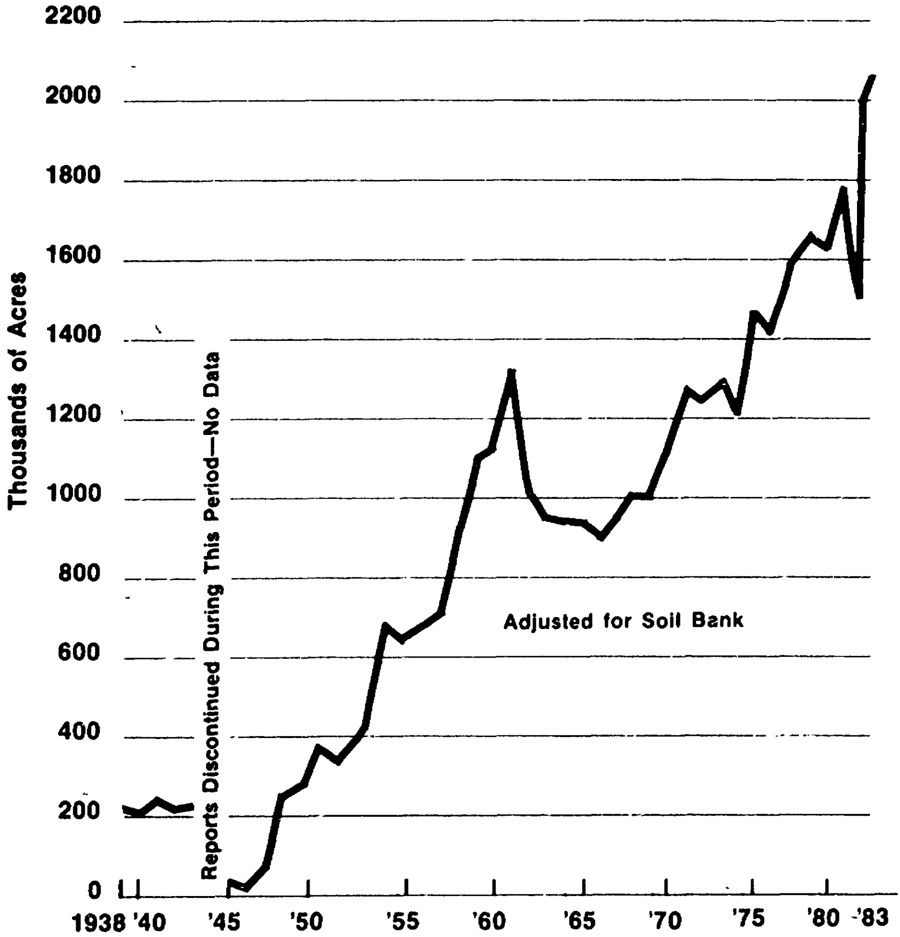
A. H. WAKEMAN
Wisconsin Woodland Owners' Association, Inc.
Madison, Wisconsin

U.S. TIMBER GROWING STOCK



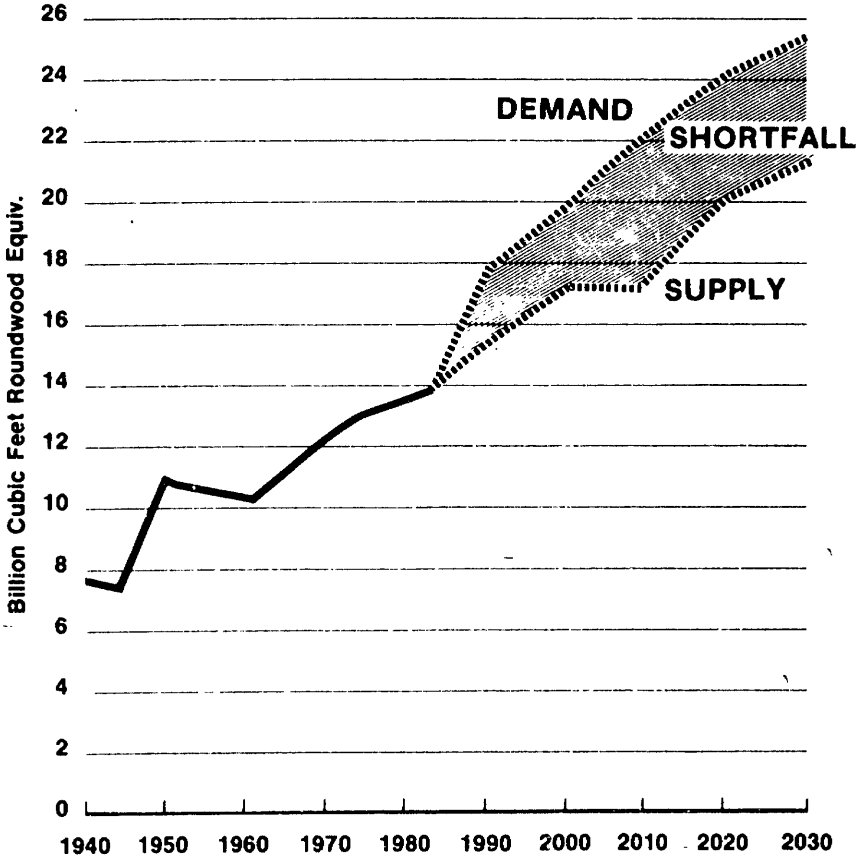
Source: U.S. Department of Agriculture, Forest Service.

ANNUAL FOREST PLANTING ON PRIVATE LAND



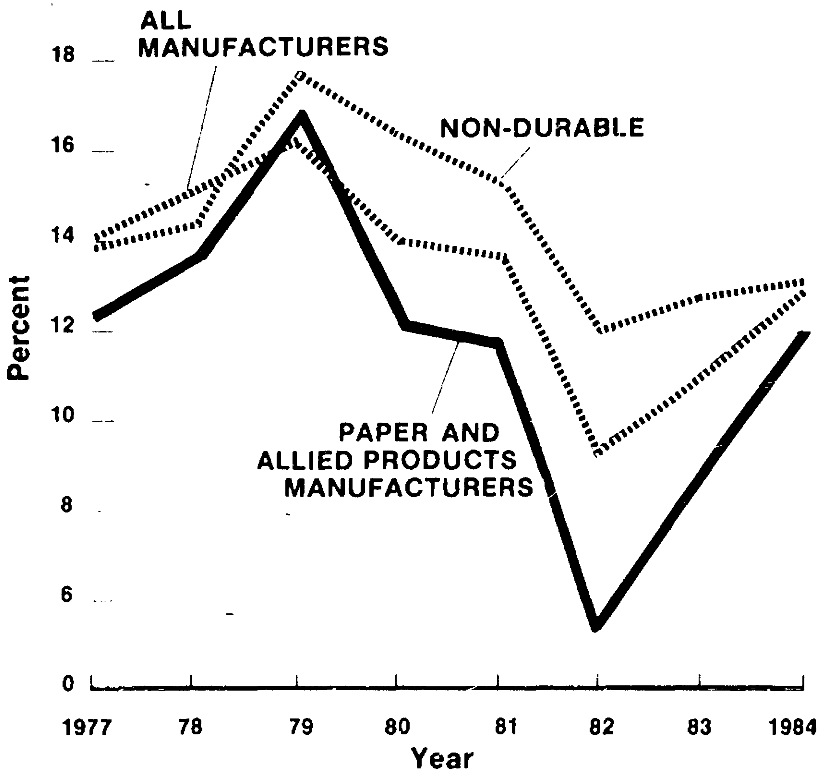
Source: U.S. Department of Agriculture, Forest Service.

U.S. CONSUMPTION AND PROJECTED SUPPLY/DEMAND



Source: U.S. Department of Agriculture, Forest Service.

RETURN ON EQUITY IN MANUFACTURING



Source: Census Bureau/FTC

STATEMENT OF ELEY C. FRAZER III, PRESIDENT, F&W FORESTRY SERVICES, INC., ALBANY, GA

Mr. FRAZER. Mr. Chairman, members of the panel, ladies and gentlemen, I am Eley Frazer and I am here to represent the Industries Committee on Valuation and Taxation, the association of consulting foresters, including the Forest Farmers Association, and the Georgia Forestry Association, of which I have been a member for 20 years. Myself, because I own three small farms—40, 60, and 80 acres on which I was raised—which were cotton farms and which are now timber farms, that I hope to leave to my children. And as a representative of some 300,000 acres owned by landowners of 100 and 600 acres in size generally we generally represent, in my consulting business, the small, nonindustrial landowner in the Southeast. The present proposed tax bill, Treasury II, is not fair nor simple. It takes 25 years to grow a stand of timber in the Southeast and longer in most places in the Nation. During that time that this timber is growing, it is exposed to the risk of fire, wind, storms, ice, flood, drought, insects, disease. What other commodity in our economy is exposed to so many risks over such a long period of time? Forestry landowners are singled out in Treasury II. What other industry is denied the expenses of taxes—protection costs, management costs, taxes, local taxes, interest, and other costs—that are associated with growing the timber? None are. We are singled out and required to not be able to expense our annual costs. We are breaking faith with the forest landowner. We have had capital gains since 1946, and landowners have planted trees and have grown their forests in the expectation that they would have capital gains in years forward. Many of us have planned this for our retirement, or to leave as insurance in case we have not finished raising our families or provided for our wives. It certainly is not fair to change this law at this time. The proposal also encourages poor forestry. Those who don't practice forestry—and I can give you an example of unmanaged trees versus managed trees. Both of these trees were cut in Georgia this last week. They are both the same age. One came out of an unmanaged forest. One came out of a managed forest. These were cut 7 years ago in Maine. The managed forest and the unmanaged forest.

If tax law does nothing else, it will discourage management of forestlands because the managed lands under 1221 would not be entitled to capital gains according to the IRS. Those that did not manage the land would be entitled to capital gains. You are penalizing good management which is poor stewardship in a time that our growth and our harvest are about balanced. There just is no way that nonindustrial landowner can grow his timber. In 1980, Congress passed a law—thanks to Senator Packwood and the rest of you here—which allowed us to take a $10,000 cost of regeneration, expense it over 84 months, and get a 10-percent investment credit on it. This one act has put more trees in the ground than anything that has happened recently. If you look at any of the statistics, you can see that from that point in time, the figures went up. At a time when we are struggling to grow timber, at a time when farmers are in problems, when on one side you are asking for billions of dollars to bail the farmers out, we are going to do the very thing that will dry up our timber supply in the Southeast and across the Nation. If you do pass this law, you are going to be back here in a few years appropriating money to put these trees in the ground, and that won't do any good because you will have lost that period of time. It takes 25 years to grow the crop. Those acres that are idle during that time cannot be made up.

The CHAIRMAN. You mean if we appropriate the money, we can't make them grow faster? [Laughter.]

Mr. FRAZER. Mr. Briggs had an idea there: You can only produce a baby in 9 months—if you put 10 men on the job——

[Laughter.]

Mr. FRAZER. You can only grow a tree in 25 years if you put 1,000 men on the job. [Laughter.]

My point to you, and I will try to summarize. I had an uncle who was a Presbyterian minister, and he said no sinners were saved after 12, and I realize that the time is up, but I say to you that this law, this bill is nonproductive and ill-advised because it not only hurts the timber industry, you will not get more income except maybe a little bit for a short time. After that time, there will be no trees to sell and no income tax to apply to the timber farmer because he won't have any trees to sell.

The CHAIRMAN. I will have to ask you to stop.

Mr. FRAZER. All right, sir. I implore you to defeat this bill.

The CHAIRMAN. You have convinced me.

Mr. FRAZER. All right, sir.

The CHAIRMAN. Dr. Yoho.

[The prepared written statement of Mr. Frazer follows:]

SUMMARY OF

ORAL STATEMENT OF ELEY C. FRAZER, III

President
F & W Forestry Services, Inc.

before the

SENATE FINANCE COMMITTEE

July 10, 1985

I am Eley Frazer, President of F & W Forestry Service, Inc. I am also pleased to represent the Forest Industry Committee on Timber Valuation and Taxation and cooperating associations including particularly the Forest Farmers Association and the Georgia Forestry Association.

The Administration's proposal is unfair to the timber owner, especially the small timber owner.

First, it discriminates against those timber owners who manage their timber resource in favor of those who ignore good forestry practices.

Current law treats virtually all timber dispositions the same and provides the timber owner with the capital gain treatment regardless of whether he disposes of his timber by a lump sum sale, by a cutting contract, or by cutting it himself. By contrast, the proposal would provide capital gain treatment only to those taxpayers who do not manage their timber and who sell their timber outright. Everyone else will be taxed at ordinary rates.

This simply does not make sense. If a taxpayer follows good forestry practices, and manages his trees for a maximum yield, he would get ordinary income on their sale. But if he ignores his trees and allows his timber property to grow helter-skelter, he is getting rewarded by capital gain treatment on the sale of his timber.

In addition, the proposal treats management costs, property taxes, and interest incurred by timber owners unfairly. Owners of other assets who incur these costs are, both under current law and the proposal, permitted to deduct them as incurred. There is no valid reason to treat timber owners differently.

Indeed, the proposal seems to be at cross-purposes with a recent addition to the Code regarding reforestation incentives. These were enacted by Congress in 1980 to permit small timber owners to deduct a limited amount of their reforestation costs, costs which have to be capitalized and otherwise could not be recouped until the timber was cut. This incentive, together with an investment tax credit worth no more than $1,000 annually would also be repealed by the proposal.

The cumulative effect of these provisions -- the capitalization of timber management expenses and carrying costs and the repeal of the reforestation provisions -- will undoubtedly result in many small timber owners' declining to make the necessary out-of-pocket expenditures to better provide for their forest investment. As it is already, for many of these owners, the economics of timber growing is marginal. The changed tax rules would make a bad situation worse.

In addition, the proposal is not simple. Indeed, for the small owner, the recordkeeping required would be especially onerous. Records would have to be maintained for all expenses, property taxes and interest until the cutting of the trees on account of which they were incurred -- 20, 30, 40, or more years. Many of the small timber owners already have a difficult enough time under current law in determining the cost of their trees. The new rules, with the inflation adjustment, will confuse and befuddle even the most sophisticated timber owners.

Finally, and what in the minds of many timber owners is perhaps most important, the proposal breaks the faith. Timber owners have planted their trees since 1944 relying on the availability of capital gain treatment on their harvest. The new proposal changes the rules in the middle of the game and is thus unfair.

Mr. Chairman, for all these reasons, I join with Mr. Roberts and urge the Committee to retain the existing tax treatment of timber.

STATEMENT OF DR. JAMES G. YOHO, PROFESSOR OF FOREST INVESTMENT, DUKE UNIVERSITY, DURHAM, NC

Dr. YOHO. Good morning. I am Dr. James G. Yoho, professor of forestry investment at Duke University. Over the years, I have held a number of academic and research positions in forestry, including professorships at several universities, a Fulbright lectureship in New Zealand, plus overseas professional experiences. I have also spent some 15 years in managerial positions in the forest products industry. The views I am presenting here today are my own, but I believe they are shared by an overwhelming percentage of the Nation's professional foresters, including those in the academic community and particularly forest economists. Currently, I am chairing the Society of American Foresters task force on Federal forest taxation, which is reviewing the SAF policy position on such matters. This review by the Nation's professional forestry organization, however, will not be completed for at least several weeks. The Society of American Foresters, though, has consistently supported timber capital gains taxation as now embodied in sections 631(a) and 631(b) of the Internal Revenue Code. The society has supported this approach for the taxation of timber-derived income since the inception of such legislation. The SAF has held that this is the most effective policy to encourage sound forest practices on the Nation's privately owned timberland, whether they be small tree farms or large industrial holdings. The SAF most recent position statement on this subject is included with my statement, and I would like to be made a part of the record. America is heavily dependent upon its privately owned forest lands to satisfy our broad demands for forest products. We happen to be the world's leading producers and also the world's leading consumers of pulp and paper products. And the second largest producer and consumer of solid wood products. Some 70 percent, or about 350 million acres of our most productive forestlands are in private ownership. Furture timber supplies depend directly on the forestry investments these owners make today, but the most recent Government examination of this situation, which you saw earlier, indicates that we face a widening shortfall between raw timber supply and the demand for wood products during the period 1990–2030, unless we intensify our level of forestry investment. And it is very unlikely that foreign sources can be relied on to close this gap over the long run. It is intriguing to me to note that the accomplishments of our private forestry sector in the decades following World War II have been the envy of the rest of the world, most of which depends chiefly upon government-owned enterprises for forestry production. Much of this private sector progress, incidentally, must be ascribed to the enlightened Federal forest tax policies which have prevailed since 1944. The forestry profession has always recognized that long-term, stable ownership of private forestland is far more conducive to the practice of sound economic and technical forestry than frequent changes of ownership. Thus, the forestry profession has consistently supported public policies, including a tax system that encourages long-term forest ownership, whether they be large or small holdings. What is difficult to understand is that the main burden of the administration's forest tax proposals will fall on owners who are actively managing their forest properties and who are actually raising their long-term levels of timber productivity.

In contrast, forest owners who do not manage their timber and dispose of their timber outright through either lump-sum sales or sales of the entire property would be eligible for capital gains treatment. The changes proposed by the administration would be a direct discouragement to all forms of tree farming. It would turn the clock back to pre-1944. It violates the most fundamental prerequisite to productive forestry, that is, intensive forest investment. And it discourages stable private forest land ownership. Likewise, intensive forestry investment would not be encouraged by the newly proposed requirement to capitalize all management maintenance and interests costs, as well as property taxes over the history of the investment, which may be 30 to 50 years. This would constitute a complex and unbearable recordkeeping burden for forest owners and substantially increase the amount of deferred return capital required in private forestry investments. This will have the effect of discouraging investments in regeneration and in long-term timber growing.

The CHAIRMAN. I have to ask you to conclude, Dr. Yoho.

Dr. YOHO. OK. It is my view that it is of critical importance to forestry and the competitive position of our economy—our forest economy in particular—in both domestic and foreign markets to maintain the current Federal approach to timber taxation. Thank you very much, Senator.

The CHAIRMAN. Thank you.

[The prepared written statement of Dr. Yoho follows:]

STATEMENT OF DR. JAMES G. YOHO

Professor of Forestry Investment
Duke University
before the

SENATE FINANCE COMMITTEE
July 10, 1985

Good morning. I am Dr. James G. Yoho, Professor of Forestry Investment, at Duke University. I have also served as professor of forest economics at Purdue University and as Dean of the School of Forestry at the University of Mississippi. In addition, I have served for a number of years in private industry.

The views I present today are my own, but I believe they are shared by an overwhelming number of professional foresters, as well as the forestry academic community.

I am now chairing the Society of American Foresters' -- the U.S. professional foresters organization -- Task Group on Federal Forest Taxation, which is conducting a review of SAF's policy on federal forest taxation. This review will not be completed for several weeks, as I recently told the Chairman in correspondence.

The Society of American Foresters has consistently supported timber capital gains taxation as now embodied in Sections 631(a) and 631(b) of the Internal Revenue Code. The Society has supported this approach for the taxation of timber-derived income since the inception of this legislation. SAF has held that this is the most effective policy to encourage sound forest practices on the nation's privately owned timberlands, whether they are owned by small tree farmers or by large industrial corporations. The SAF's most recent position statement is dated January 10, 1985, and is included with my statement.

About 350 million acres, or some 70 percent of the total U.S. commercial forest acres, are privately owned. This 70 percent contains 48 percent of the U.S. standing timber volume and it produces 62 perecent of the nation's annual timber harvest. Roughly one-third of the privately owned commercial forest land is owned by farmers, about one-fifth is owned by forest products companies, and the remainer is owned by individuals or firms not connected with farming or the forest products industry. In all, there are some 7.7 million separate forest landowners whose holdings vary in size from a few acres to more than a million acres in a few cases.

The nation depends heavily on these lands for forest products: softwood and hardwood lumber and plywood, poles, pilings, plus a wide range of pulp and paper products. The U.S. is the world's leading producer and consumer of pulp and paper products and the second largest producer and consumer of solid wood products.

One government study after another has shown that we face a widening shortfall between raw timber supply and demand for wood products during the period 1990-2030, unless we increase the level of forestry investment -- and by this I mean the intensity of forestry practices -- on our more productive forest acreage. Our private forest lands have been, are now, and are potentially the nation's most productive forest lands.

This potential productivity is heavily dependent on the rate and intensity of private forest investment. Under an enlightened tax system since 1944, we have had a record of accomplishment that is the envy of the world -- all the result largely of relatively stable government policies designed to counter somewhat the discouragements inherent in a low-yield, deferred-return investment area.

The forestry profession has long recognized that long-term, stable ownership of private forest land is far more conducive to the practice of sound economic and technical forestry than frequent changes of ownership. Thus, the forestry profession has supported enlightened and stable public policies, including a tax system, that encourages long-term ownership and discourages fast turnaround in ownership.

What's difficult to understand is that the greatest burden of the Administration's proposals will fall on owners who are actively managing their forest properties and actually raising their long-term levels of timber productivity. These are the properties we must rely on to furnish the nation's timber supply over the long run. Forest owners who dispose of their timber outright through either lump-sum sales or sale of their entire property would be eligible for capital gains treatment at lower effective rates than for ordinary income.

This would be a direct discouragement to all forms of tree farming. It would turn the clock back to pre-1944. It violates the most fundamental prerequisite to the practice of intensive forestry -- intensive forestry investment -- and it discourages stable private forest land ownership.

Certainly intensive forestry investment would not be encouraged by the newly proposed requirement to capitalize all management and maintenance costs and property taxes over the history of the investment, which may be 30 to 50 years. Not only is this a complex and unbearable record-keeping burden particularly for small owners it also would impose a serious burden on the ability of timber owners to regenerate their lands for the long time required.

For the reasons I have cited, it is expected that the Society of American Forester's Task Group will support the consistent SAF policy on taxation of forest-derived income. In my view it is of critical importance to forestry and the competitive position of U.S. forest resources in both domestic and foreign markets to maintain the current federal approach to timber taxation.

Thank you.

The CHAIRMAN. Mr. Frazer, let me ask you a couple of questions. You actually own wood lots. You raise timber?

Mr. FRAZER. Yes, sir.

The CHAIRMAN. And you supplied us with these examples. Right?

Mr. FRAZER. Yes, sir.

The CHAIRMAN. All right. This is a 25-year-old tree in an unmanaged forest?

Mr. FRAZER. That is right.

The CHAIRMAN. And you can tell it by counting the rings?

Mr. FRAZER. Yes, sir.

The CHAIRMAN. This is a 25-year-old tree in a managed forest?

Mr. FRAZER. Yes, sir.

The CHAIRMAN. You can also tell it by counting the rings?

Mr. FRAZER. Yes, sir.

The CHAIRMAN. You have a ring a year.

Mr. FRAZER. A ring a year.

The CHAIRMAN. Clearly, to make the tree grow this big, as opposed to this, you have got to spend some money.

Mr. FRAZER. Yes, sir.

The CHAIRMAN. What do you do? Let's get down to very simple and lay language. What kind of money do you have to put out to make the tree get this big?

Mr. FRAZER. Right now, when you harvest a stand, it costs, I would say, on the average of $150 an acre to prepare the land and to replant the tree, and then, each year thereafter until maturity, you have a cost of about $3.50 to $5, according to the stand in maintenance costs, management costs, fire protection, and this kind of thing.

The CHAIRMAN. An acre?

Mr. FRAZER. An acre.

The CHAIRMAN. $3.50 to $5 an acre.

Mr. FRAZER. Yes. In addition to that, in the State of Georgia, we have ad valorem taxes that probably average $3 to $3.50 an acre. The ad valorem tax is on top of this, so you are talking about something in excess of $6 an acre, or $7 an acre, is an annual management cost.

The CHAIRMAN. You don't need to worry about those because the administration is going to get rid of the deductibility of those taxes, anyway.

Mr. FRAZER. That is what is worrying me. [Laughter.]

Also, you have the cost of the danger of insects, disease, and today we are talking about millions of acres burning up in California. How would you—if you had your investment in that—pay $150 plus $350 an acre land—how would you feel about your investment?

The CHAIRMAN. At the moment, you put your $5 or $6 or $7 or $8 an acre, counting the taxes on it—your are entitled at the moment to deduct that as a business expense.

Mr. FRAZER. That is right, but that does not include any interest, Senator.

The CHAIRMAN. No; I understand that. That assumes that you actually had the cash to put into it. If you are borrowing money, you have interest to deduct.

Mr. FRAZER. Which most of us don't have.

The CHAIRMAN. I understand that. Most of you have to borrow if you are going to make it go. Now, under the administration's bill—now, you have put out your $7 or $8 or $6 an acre to make this tree grow this big. You are going to be expected now, as I understand it, to simply eat that until you sell the tree. You are going to have to have enough cash or enough borrowing capacity or some access to liquidity to put that money on your forests until you can finally sell it.

Mr. FRAZER. Senator, if I put that money out today and pay it, I am going to be 84 years old before I can get my money back, and then who knows? I may not be here to get it back.

The CHAIRMAN. Well, you look like you will. [Laughter.]

Mr. FRAZER. I fully intend to.

The CHAIRMAN. What I am asking is how many people are in a position to put out $5 or $6 an acre for 100 acres or 500 acres or 5,000 acres, year after year after year and not be able to deduct it in the hope that when they sell the trees 20 or 30 years later, they will recover the money they have put out?

Mr. FRAZER. This is the reason I am sitting here before you with my hat in my hand. This proposal—this bill—will wreck the forest industry in the United States. Certainly, nobody can afford to do the things that we are talking about. We only have a 2- to 5-percent real return on our money now in tree growing. If you do these things, there is no way that we can get the capital to grow the trees. That is the reason I said we are going to be back here with our hat in our hand to get Congress to appropriate the money to pay the man to plant the trees if we pass this regulation.

The CHAIRMAN. Let's change and talk just a moment about the maximum $10,000 investment and the $1,000 credit that you get for reforestation. This was added to the law in 1980 almost as an after-thought. The bill basically involved sale of timber off public lands and the establishment of a forest fund for reforestation with the Forest Service. Someone suggested that there existed a lot of private wood lots, and that that should be encouraged. Again, I want to emphasize for the record. This is not an immense tax credit. The maximum credit is $1,000. The maximum you can invest to get it is $10,000. Now, for Mead Corp. or Weyerhaeuser, that might be relatively—a relatively—small investment. Now, isn't it true that for many, many tree lot owners that is a very significant investment and that credit is a very great inducement to reforest your lands?

Mr. FRAZER. Senator Packwood, that has been the biggest inducement that has come along since the soil bank. My clients—the ones that own from 1 to 600 acres—to plant trees. They can get their investment, up to $10,000, over a reasonable period of time.

The CHAIRMAN. Tell me what happens if, in addition to losing the credit, in addition to losing the expensing, you now lose the capital gains when you finally do sell the tree?

Mr. FRAZER. Then, you have to pay ordinary income on the sale of the trees unless you practice poor forestry—or practice no forestry.

The CHAIRMAN. Unless you get out of the business of reforestry and just cut your trees and say that is it—I am now done.

Mr. FRAZER. That is right.

The CHAIRMAN. Which is not the policy we have wanted to encourage in the past.

Mr. FRAZER. If we have that kind of policy, you saw that the growth and harvest curve was about to cross. Somewhere we are going to have to have timber to supply this industry. And this is a big thing in the Southeast, and I think 6 out of 12 States, the timber industry is first or second in the economy.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Gentlemen, I think it is clear that the proposal does treat the timber industry unfairly compared with other industries. It would help us on this panel, however, if you could more precisely delineate the degree to which this proposal would adversely affect the timber industry in America, either domestically or in terms of our international competitive position. I know that in the last year or two many American firms have been suffering and losing out to other companies and other countries for various reasons—including but not limited to the overvalued U.S. dollar. My request to you is that you specify as precisely as you can—in terms of dollars and cents or volumes of sales the effect enactment of this proposal would have upon the industry, particularly with respect to our international competitive position.

Mr. ROBERTS. Senator, let me try to take a pass at that. Clearly, on the competitive standpoint, as you well know—and within the last year and a half in the forest products industry—we have totally switched our competitive position with the Scandinavians who are providing the timber and the wood much cheaper. And as you know, each of the countries has special tax treatment for timber. Every country has that; and the States do with ad valorem. What would happen here, as Eley has said, there is no question that the costs would go up dramatically for us. We get our wood from these gentlemen. It is very important we have that or we are not going to be able to turn out any international product, such as liner board, any kind of wood that we are sending abroad. Forgetting the impact of the dollar, I would think that our costs would go up at least another 15 to 20 percent—just by their having to delay getting their payment on any of the capitalized items and the capital gains being repealed. And already we are running about 30 percent behind because of the dollar. We think it would have to change much for us to get into a competitive mode in our industry. Those are ballpark figures, but it would certainly hurt the balance of trade that we are going through. And we are selling in the EC countries, Japan, and so forth.

Senator BAUCUS. As best you can, can you give us some idea of some flavor of treatment that other countries give? I know Canada, for example, has low stumpage rates. I am curious. What else does Canada do and what do other countries do?

Mr. ROBERTS. Canada does several things. Forgetting stumpage for the moment. As you know, Canada's land is crown land. I am now going to skip from the timber a little bit into Canada's capital cost allowance. If you build a facility in Canada—a pulp mill—pulp mills these days cost about $300 million—you can for every dollar of income that you make on that mill, apply directly against the capital cost. I realize that is not timber, but I am talking about this because if I could make $30 million in 1 year, I can apply that without any taxes straight against that $300 million capital spent. That is a great incentive, frankly, to build in a timber resource such as Canada. Other countries don't have quite that, but they do have various advantages for timber owners, but I think under the new tax proposal we would probably be the only country that does not give any kind of special allowance.

Senator BAUCUS. So, what you are saying is, first, that other countries give some favorable or special treatment to the forest products industry; second, American firms have to compete against the burden of the overvalued U.S. dollar; and, third, if this proposal were to be enacted into law, that it would cost the forest products industry, around another 15 or 20 percent, which would put the U.S. forest products industry at that much more of a disadvantageous competitive position?

Mr. ROBERTS. It would be my rough—very rough—estimate. Yes.

Senator BAUCUS. All right. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. While I have the chance, I want to get a little bit of information about our trade situation compared to Canada. The Canadian trade minister was in this town a few weeks ago, and he couldn't understand why we were complaining about imports of Canadian lumber. He felt that they were only increasing in their share of our market by about 3 percent a year, and he didn't understand why we would complain about that. Now, does your company have any investments in Canada, Mr. Roberts?

Mr. ROBERTS. We have major investments, so you see, I am a little bit on both sides of that post. We have major investments in Canada.

Senator LONG. You have mills over there as well?

Mr. ROBERTS. Yes; we have mills. We have sawmills and have pulp mills, scattered pretty much across the country.

Senator LONG. It may be that we ought to ask somebody else to answer the question. [Laughter.]

Mr. ROBERTS. But I understand exactly what you are saying.

Senator LONG. Would you please give us—just in the order of significance—what are the main advantages that Canada has going for them over American producers? They are gaining in our market, and we are losing ground. Can you give us the items, in their order of significance, that are helping the Canadians expand in our market while we are losing in our own market?

Mr. ROBERTS. One of the things I would go back to is Canada's capital cost allowance. In effect, when I cut through everything I have told you on the building of a mill, what you are getting your cash back twice as fast as when you build it in the United States because you are, in effect, getting that cash through not paying taxes for you are applying that earning against capital expenditures. And so, what you do is cut the return on that investment about in half.

Senator LONG. Yes, sir. Tell us about the stumpage, the Canadian practice compared to our situation here.

Mr. ROBERTS. Stumpage, of course—it is crown land, as you know. Now, the way that is calculated is that you pay for the stumpage as you use it, and it is a percentage of the selling price at the time. In other words, you pay a given percent of what the selling price as reimbursement for that stumpage that you use. It is changed quarterly. In other words, if the selling price were to change, cost of stumpage would float with the selling price.

Senator LONG. Now, I hear Americans that argue that the Canadians make that percentage as low as they have got to make it in order to invade this market. Is that correct or not? I just want to know.

Mr. ROBERTS. It is an extremely complex mathematical equation that you go through to get this. I probably am of the school that it is probably not as great a spread as frequently is announced as far as the leverage that you get on crown land.

Senator LONG. But Mr. Frazer, you don't have any investment in land in Canada, do you?

Mr. FRAZER. Senator, I don't have any investment up there, and I said here 5 years ago, when I was testifying before this same committee on the investment credit, and I heard then that they were paying $15 a thousand for it—or $14 a thousand for it. And I hear now that they are paying $5 a thousand, but that doesn't matter to me. The part that matters to me is that 60 percent of the lumber that is sold in the State of Georgia is Canadian lumber. They have got to have some advantage, I will guarantee you, because they are putting us out of busniess.

Senator MITCHELL. $2 a thousand in British Columbia.

Mr. FRAZER. You know, these are the figures I hear, and I can't say that is absolute truth because I don't cut any Canadian timber.

Mr. ROBERTS. There is clearly no question that there is a great deal of Canadian lumber coming in here. It is sometimes a little difficult to figure out quite where all the cost benefits are coming that does make it doable from Canada, but clearly, there is probably some from the crown land—the stumpage. Again, just the way their capital appreciation works gives them some advantages on their costs so that there is benefit that can be passed on.

Senator LONG. Dr. Yoho, can you give us some of your thoughts on this subject?

Dr. YOHO. I think the one point that hasn't been mentioned in connection with is that I think there are definitely transportation advantages also. Again, it is a complex situation, but I think the Canadians do come out ahead in terms of the—if I might use the word—assistance they get one way or another in the area of transportation.

Senator LONG. Could I ask you this? Would you tell me what other things are occurring that are advantages that the Canadians might have in this market, Mr. Roberts? I just want to know what our problem is compared to Canada.

Mr. ROBERTS. What kind of advantages they would have?

Senator LONG. You mentioned two.

Mr. ROBERTS. Transportation. I think the other situation these days in Canada—you know they have a substantial amount of problems. I think one of the things is they are frequently willing to settle for a lot less return than perhaps other countries would. Again, the dollar is strong. It has had a major impact. And the share of Canadian lumber coming in is traced directly related to the value of the Canadian dollar.

Senator LONG. Yes, sir. How much would you say our dollar is undervalued or overvalued compared to the Canadian dollar?

Mr. ROBERTS. We feel that the U.S. dollar has weakened about 8 or 10 percent in the last couple of months. Up until then, we had felt that it had to weaken by about 30 percent to get us back onto an even keel.

Senator LONG. But you think recently it is down to 8 or 10 percent?

Mr. ROBERTS. It has weakened a little in the last year, as you know, or the last few months.

Senator LONG. I want to ask one other question, if I may. You put a chart up there, and maybe you can find that chart and put it back up again because I want to ask a question about the chart on annual planting.

Mr. ROBERTS. Right.

Senator LONG. Would you mind putting that chart back up again so I can ask a question about it?

Mr. ROBERTS. Yes; here it is.

Senator LONG. Fine. Now, just looking at that chart, how the annual planting keeps going on up, if I was just sitting here with no knowledge about this business at all, I would just say: What are you guys complaining about? You have more and more people planting, and the line keeps going up. And the last thing I see, you are about to cross the 2,000 mark. What is the problem? I mean, one would think you ought to be all smiles at the rate that that line is moving up.

Mr. FRAZER. That is the reason we are here. We are not all smiles. If you see the first spike there——

Senator LONG. The what?

Mr. FRAZER. The first spike that is 55 to 60? You see how that planting went way up?

Senator LONG. Yes, sir.

Mr. FRAZER. Do you see how it has tailed off after that?

Senator LONG. Yes, sir.

Mr. FRAZER. And you see there—previous to that—that it starting coming down. And then we got the Packwood bill, and see, we started up again.

Senator LONG. Yes, sir.

Mr. FRAZER. We need these things to maintain our balance between growth and——

Senator LONG. I voted for the Packwood bill. But now, do I understand that your feeling is that if this proposal passes, that that line is going to quit going up and start back down? Is that what you are complaining about?

Mr. FRAZER. My feeling is that if we do not do what we are talking about here today—before the Packwood bill, you see the direction of the spike there?

Senator LONG. Yes, sir.

Mr. FRAZER. That is the way we are going—not up. So, we will reverse that upward trend to a downward trend.

Senator LONG. Could you be a little more specific about these exhibits you gave each member of the committee? What happened to this tree?

Mr. FRAZER. What happened to this tree? It grew unattended.

Senator LONG. Well, it looks like something must have gotten to it——

[Laughter.]

Mr. FRAZER. It was in crowded conditions. It had no prescribed person to look after it. It probably was a tree that the insects didn't attack. It probably was depressed by the other trees. Now, this tree grew in attended conditions. It was thinned when it needed thinning, and they had a prescribed fire when the prescribed fire was needed, and things were done to it. Now, you could let this one stay that way forever, and it is just about through growing. That is about as big as that one was going to be. This tree with continuous growth, it will continue to produce well—but not as well as it has in the past because it is time to cut it—but that is the difference. You can make the trees. You can utilize the site, and this effect won't always be that dramatic. That is what you are looking at.

Senator LONG. Do we have time for another comment on that?

The CHAIRMAN. I want to get to the other Senators, if I can here, because I know they have got some more questions. Do you want Dr. Yoho to comment on that?

Senator LONG. I just wanted to hear what he has to say.

Dr. YOHO. I just wanted to comment about that line. We have to keep up this planting rate in order to hold our own because, I think, sir, you remember from your boyhood days in the South that most of the timber that was regenerated in those days seeded in naturally over cutover land or on old farmland, especially old farmland. That land is no more. We have to resort to costly site preparation and planting now to hold our own. And that is where these tax breaks, of course, help substantially. There is a new Forest

Service study about to be published on this very thing that concentrates on this problem in the South.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. I think, following up on Dr. Yoho's statement, that that chart is relevant only when read in conjunction with the other chart that is entitled "U.S. Consumption and Projected Supply and Demand." And I wonder if you would put that one up there. That is the relevant chart. In other words, the amount that you have on hand is an interesting statistic, but it is relevant only in relation to what demand will be. Now, that is based upon a projection by this administration. That is, the very administration that is proposing the changes in the tax bill is also projecting that demand. I would like to ask a question for each of you to comment on. The administration's explanation of its proposal—the required capitalization of timber management costs—says, and I quote now the administration: "A large number of tax shelters involve the so-called natural deferral industries, such as timber." In your knowledge and experience, is that true? Is there a widespread marketing of tax shelters associated with the management of timber resources?

Mr. FRAZER. That is one of the problems that we have—getting investment in forestry. We tell them we don't have any tax shelters. We have capital gains, but there is no tax shelter in timber as compared to the other businesses, such as——

Senator MITCHELL. So, your answer, Mr. Frazer, is that based upon your own knowledge and experience—to that extent, your answer is no. You don't agree with that administration statement.

Mr. FRAZER. No. No; I don't agree with that statement. The only time we get any tax breaks at all is when we spend money and get it back, over long periods of time.

Senator MITCHELL. Yes.

Mr. FRAZER. No; there is no tax shelter. No.

Senator MITCHELL. Dr. Yoho, do you have any knowledge or experience in this area?

Dr. YOHO. To some extent. I would certainly agree with Mr. Frazer. We don't have tax shelters in forestry in the sense in which the word is ordinarily—the term is ordinarily used. Of course, it is a cost recovery depletion type of allowance that we get.

Senator MITCHELL. I realize that. So, you dispute the administration statement as well?

Dr. YOHO. Yes.

Senator MITCHELL. Mr. Roberts.

Mr. ROBERTS. I would dispute that, too. I don't—we do not have those kind of tax shelters.

Senator MITCHELL. And Mr. Condrell, you are a lawyer with Mr. Roberts?

Mr. CONDRELL. Most tax shelters are dependent upon noncash deductions. Depreciation is an example. An apartment house would borrow the money and write off the depreciation. It all comes out as a way of sheltering nontax income. In the case of timber, all the money put into the ground that Eley was talking about and the others, is cash investment. So, there is no sheltering of timber in the same way that there are tax deductions for most shelters.

Senator MITCHELL. I would like each of you to tell me, in your opinion, which is more important in encouraging a sufficient supply of timber in the future, that is, to eradicate that shortfall that shows on that chart. The capital gains treatment of timber sales or the expensing of timber management costs? Begin any way you would like.

Mr. ROBERTS. It is a tough question. I would say—it hurts me to say that. I would have to say the capitalization of the costs would be the most detrimental although—I think capital gains is equally serious.

Senator MITCHELL. Mr. Frazer.

Mr. FRAZER. I would agree with Mr. Roberts, but I would say this. We can't do without any of the three, if you don't expect to get in trouble.

Senator MITCHELL. Yes; by the three, you mean the 84-month amortization for timber reforestation costs?

Mr. FRAZER. The three things that Treasury II is trying to wipe out.

Senator MITCHELL. Yes.

Mr. FRAZER. We need them, and even with them, we are predicting—shortfall.

Senator MITCHELL. Is the answer dependent to some extent upon the nature, size, and location of the holdings of the person responding?

Mr. FRAZER. Yes, sir, I think so. I think that I would agree with Mr. Roberts because a man who puts money out of his pocket and puts it into the ground and then not have the maintenance costs and his taxes and all deductible—he is just not going to do it.

Senator MITCHELL. Yes. Dr. Yoho, what is your answer to that question?

Dr. YOHO. I would think it would depend on the individual investor. I think in one case capital gains might be more important to one investor, whereas the write-off would be more important to another, but both are certainly important in the overall outcome.

Senator MITCHELL. So, the answer would vary depending upon who the person you asked?

Dr. YOHO. Yes, sir.

Senator MITCHELL. All right. My time is up. I thank you, gentlemen, and thank you, Mr. Chairman.

The CHAIRMAN. Senator Pryor.

Senator PRYOR. I wish I had the exact quote. I don't have the quote, Mr. Chairman, but I am going to paraphrase the President. I think it was in his weekly radio address recently. And I am going to ask each of you a yes or no answer. The President said—and I will try to paraphrase this—if the Congress sends to me any tax increase, disguised or undisguised, I am going to veto it—any tax increase. And then he went on to say we should not pass any new taxes, or he would veto them. Now, the question, yes or no. Do you gentlemen feel like this is a tax increase? Mr. Roberts.

Mr. ROBERTS. We have done a little—as much work as we can on this.

Senator PRYOR. I am trying to get a yes or no answer.

Mr. ROBERTS. I know you are. The amount of what we are talking about is so nominal, I guess I would end up saying it is not a tax increase. In 1990, that capital gains would be about $200 million—that is all we are talking about. So, I am going to say that, the way the figures are rounded, the answer is no.

Senator PRYOR. Mr. Frazer.

Mr. FRAZER. Yes, sir. It is going to be a tax increase for my folks.

Senator PRYOR. Dr. Yoho.

Dr. YOHO. No doubt about it, I think it will be a tax increase, for this sector of the economy, which can be a very critical factor for this sector of the economy. In terms of the total GNP, it may sound insignificant.

Senator PRYOR. So, two-thirds of you say this is a tax increase. And if you took the President literally, he would have to veto his own bill if we kept this new treatment of timber in the legislation, I guess. Is that what you are saying?

The CHAIRMAN. I quizzed the President about this one time when we were there. There are clearly tax increases in this bill, especially for capital intensive industries. Repeal of the investment tax credit—in addition to the recapture provision for investment tax credit—will certainly mean a tax increase for some. When he means revenue neutral, he means overall. And that is fine if you are one of those who isn't getting too neutralized——

[Laughter.]

Mr. FRAZER. Yes; if you don't fit into the overall category, I guess you are right.

Mr. ROBERTS. Mr. Chairman, can I clarify? I guess I misunderstood.

Senator PRYOR. Mr. Roberts already answered that question but if you would like to expand on it.

Mr. ROBERTS. It is a major increase to the Government, Yes. It is a major increase to the individuals. I misread your question.

Senator PRYOR. All right. Thank you, sir. I was just trying to make a point here. Now, Mr. Frazer, under the plan as proposed, as I understand it, it seems that a landowner who sold all his timber—say he had 500 acres of timber in one block and he sold all that—he could still receive the capital gains treatment, but an individual landowner—and I imagine you represent some of those—who has just sold, say 100 acres of that timber and then replanted that 100 acres—he wouldn't get any more money from that 100 acres for another 40 or 50 years. Now, this individual is going to be taxed at ordinary income rates. Is that correct? Am I reading the proposal correctly?

Mr. FRAZER. It is my understanding, as a layman, that even if he sold the 500 acres and he was practicing good forestry on it before he sold it—I mean the timber—then he would still not get capital gains on it. If he practiced no forestry on it, and he sold the 500 acres, he would get it. But definitely, if he sold 100 acres and replanted and was practicing forestry, he would be ruled out on capital gains.

Senator PRYOR. That is my interpretation of it, and I hoped that was yours. The second question I would like to ask—and my time is just about up already—is what statistics might any of you have available for the committee at this time about the timber exports? Are we exporting any more timber at this time in this country? Or are we totally out of that market? We used to export a lot of timber, didn't we?

Mr. ROBERTS. We do have here that timber exports have fallen from 1.8 billion cubic feet in 1976 to ~~1.3 billion~~—or are going to fall by forecast—to 1.3 billion cubic feet in 2030. That is 1.8 billion in 1976 to 1.3 billion forecasted to fall to in 2030.

Senator PRYOR. Now, are we losing that export market to the Canadians? Is that the primary beneficiary of——

Mr. ROBERTS. Clearly, one of them would be the Canadians. Yes, sir.

Senator PRYOR. Are there other countries that are doing the same thing the Canadians are doing right now?

Dr. YOHO. Well, of course, the Scandinavians. In the pulp and paper area, the Scandinavians have been competitive for a long while. And of course, it is so important in their economy that they resort to all sorts of tactics to maintain their competitive position worldwide, such as devaluation of the currency even to remain competitive in the European market. But as far as softwood saw timber, which I think most of you are speaking about when you speak about the Canadian situation, no, there is not much of that going on. They are competing with us around the world trying to sell the same product, as well as competing here internally.

Senator PRYOR. Mr. Chairman, I have just one other question. I will submit it for the record in writing, relative to the capitalization issue. Thank you.

The CHAIRMAN. Are there other questions? Senator Baucus.

Senator BAUCUS. I have questions that we won't have time to get into. I would like to ask, though, if we could have a hearing on the problems that affect the timber industry and particularly Canadian timber imports. As you know, Mr. Chairman, the ITC is holding a fact-finding hearing on July 23 on Canadian imports, and there are a lot of questions here on taxation of the forest products industry. So I would like to ask if we could schedule a hearing generally on Canadian imports and the timber industry and include some of the questions that we are discussing today.

The CHAIRMAN. I would like to. I have spoken to Senator Danforth about a Trade Subcommittee hearing. Believe it or not, almost every morning at least is taken up for about 8 weeks through mid-September with hearings of one kind or another. We may have to sandwich it in on an afternoon.

Senator BAUCUS. That would be fine with me. The point is that there will be a lot of experts in town on July 23, so that would be a good date, or somewhere around that if you could do it.

The CHAIRMAN. Let me see what I can do.

Senator BAUCUS. Thank you.

The CHAIRMAN. Other questions?

[No response.]

The CHAIRMAN. If not, gentlemen, thank you very much. Now, let's conclude with a panel of Doyle Rahjes, president, Kansas Farm Bureau; Cal Coulter, vice chairman, Tax and Finance Committee; Chuck Hassebrook, tax policy analyst; and Robert Hanson, chairman, Deer & Co. Mr. Rahjes, why don't you go right ahead?

STATEMENT OF DOYLE RAHJES, PRESIDENT, KANSAS FARM BUREAU; AND MEMBER, BOARD OF DIRECTORS, AMERICAN FARM BUREAU FEDERATION, MANHATTAN, KS

Mr. RAHJES. Mr. Chairman, I want to thank you and the members of this distinguished committee for the opportunity to present the American Farm Bureau position concerning tax reform. I would want to preface my remarks by saying that agriculture certainly is a multifaceted industry; and if we were to cover the whole of agriculture, it would take a long time to do it, and in 5 minutes, it is going to be very difficult. You do have before you, I hope, the extended statements, and I would hope that they would be made a part of the record.

The CHAIRMAN. All of the statements will be in the record in total.

Mr. RAHJES. Thank you, Mr. Chairman. I am from Kansas, and I would indicate to you also that I am serving on the special tax committee, a study committee that the American Farm Bureau has commissioned to develop some information to be recommended to the American Farm Bureau Board at its August meeting. And I am pleased to be able today to present to you some preliminary comments based on our particular study at this time. I am a farmer and rancher from Phillips County, KS, and I would say to you that I can bring some personal experience about the present tax system that is too complicated and it is full of provisions that tempt business people to make decisions based on tax considerations rather than sound economic principles.

Our support for this bill is contingent on several things, one of them, of course, is its revenue neutrality. We are insistent that a new tax system generate no more revenues than the current system, and we must be assured of this before we lend any support to this plan. With regard to the specific provisions, we will measure them against our four tax policy objectives; one being private initiative, two economic growth, three equity, and four simplicity. As to the testimony that we might give and focus in on, first there would be about four or five points. And No. 1 would be the area in the reduction in the marginal tax rates of 15, 25, and 35 and also the graduated tax rates for corporate rates. I would only say to this that we would reserve judgment at this time on those specific rates. However, we do feel that a reduction here across the board would certainly be in line.

Speaking to the repeal of the investment tax credit, we feel that a limitation rather than the repeal would be more in order. We oppose the use of investment credits or losses incurred in one business from being used as a tax write-off in an unrelated business. In the area of the revised tax treatment of capital gains, we would say that the tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property. We support the current law with respect to capital gains treatment for the sales of breeding livestock and forestry products. Under the administration's tax plan, the livestock sector likely, and almost positively, will be hit hard. We recognize also that timber sales will be unless it is sold with the land—unless the timber would be sold with the land. Restriction of the cash method of accounting as it pertains to not having the option certainly creates some very significant problems with us. However, it may in some way be addressed with a limitation of $5 million or so.

We would like to focus in on the repeal of the alternative minimum tax, in particular in the sensitive situation in which we are seeing many farms liquidated today. We believe it should be repealed. This particular problem certainly as liquidation is occurring creates a significant problem today as one farmer or another might try to liquidate a cow herd or something like that and causes extreme hardship. And it is very, very important that we would have this tax repealed.

There are a number of things that you see in the statement, but I would like to focus in on one, and that is the capitalization of preproduction costs. This not only would cause an accounting nightmare, but it would be something which would be almost impossible to account for. We feel very strongly that this needs to be addressed and should be changed. Tax-loss farming, although we have endorsed no specific proposal, the farm bureau would discourage tax sheltering activities by limiting an individual or corporation from using the investment credit or losses incurred in one business from being used as a tax write-off in an unrelated business. The Farm Bureau believes that the best cure for tax shelter activities is a lower marginal tax rate which would reduce the incentive for tax shelters.

Mr. Chairman, I know my time is up. I would just like to make one comment. That is to indicate very generally that, as Senator Abdnor mentioned this morning, rural America is suffering, I happen to be from rural America, my home is a town of less than 300. As we observe rural America, we observe the finance problems in lending institutions and the whole gamut of agriculture, we need the attention to be given as quickly as possible to alleviate many of the problems that there are out there. Thank you very much.

The CHAIRMAN. Thank you, sir. Mr. Coulter.

[The prepared written statement of Mr. Rahjes follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SENATE FINANCE COMMITTEE
REGARDING THE ADMINISTRATION'S TAX REFORM PROPOSAL

Presented by Doyle D. Rahjes, President of the Kansas Farm Bureau
and Member of the AFBF Board of Directors

July 10, 1985

Mr. Chairman and members of the Committee, I am Doyle Rahjes, President of the Kansas Farm Bureau and a member of the Board of Directors of the American Farm Bureau Federation. Today I am pleased to appear before the Committee as a member of the AFBF Tax Study Committee. Farm Bureau's Tax Study Committee, consisting of six State Farm Bureau Presidents who represent a diversity of commodity production throughout the country, is charged with the responsibility of evaluating current tax reform proposals and their effect on farmers and ranchers. The Tax Study Committee will meet next week to compile its recommendations and forward them to the Board of Directors in August for the Board's decision. Although we have no position on a complete tax reform package at this time, I am pleased to offer the committee some preliminary comments based on current Farm Bureau tax policy. Farm Bureau policy is developed by producer members at the county, state, and national levels, and represents the views of over three million member families in 48 states and Puerto Rico.

As a farmer and rancher in Phillips County, Kansas, I bring personal experience to the Committee about a tax system that is too complicated, full of provisions that tempt business people to make decisions based on tax considerations rather than sound economic principles, and above all else emphasizes wealth redistribution at the expense of wealth creation.

In general, Farm Bureau supports tax reform that contains a system of lower tax rates for individuals and corporations. Whether or not the lower rates that have been proposed are sufficient to compensate for the elimination of certain deductions and credits will be a primary consideration for Farm Bureau as we evaluate the plans.

Our support for a flat rate income tax or a modified flat rate income tax is contingent on revenue neutrality. Farm Bureau has long been opposed to tax increases to balance the budget. We, like many other groups, are insistent that a new tax system generate no more revenues than the current system. Proponents of the reform plans, whether they advocate the Fast and Simple Tax, the Fair Tax, or the Administration's plan, argue that their proposals are revenue neutral. We must be assured of this before we lend support to any plan.

A related issue is the inclusion of indexing for rates, zero bracket amounts, and personal exemptions. Although a modified flat rate schedule with fewer brackets would restrict the hazards of being bumped into higher brackets because of inflation, the problem still exists. The income tax system must retain indexing.

With regard to specific provisions of the Administration's tax reform proposal, we will measure them against our four tax policy objectives: (1) Private initiative, (2) Economic growth, (3) Equity, and (4) Simplicity. While we have not yet taken a position on the Administration's tax package as a whole, our ultimate decision will turn on the extent to which the provisions of the reform package meet these objectives.

Mr. Chairman, Farm Bureau will focus its testimony on tax reform items where we have clear policy direction. On the items for which we have no positions, we will offer some comments and observations with the understanding that Farm Bureau leaders are studying these important
issues in preparing final positions on tax reform.

First, the tax reform areas where Farm Bureau has policy positions:

(1) REDUCTION IN MARGINAL INDIVIDUAL TAX RATES TO 15 PERCENT, 25 PERCENT, AND 35 PERCENT AND REDUCTION IN MAXIMUM CORPORATE RATE TO 33 PERCENT WITH GRADUATED RATES OF 15 PERCENT, 18 PERCENT, AND 25 PERCENT ON TAXABLE INCOME UNDER $75,000.

Farm Bureau supports a system of lower tax rates for individuals and corporations, but reserves judgment at this time on specific rates.

(2) REPEAL OF THE INVESTMENT TAX CREDIT.

Farm Bureau supports limitation rather than repeal of the investment credit. Like ACRS and capital gains treatment, the ITC is considered by some to be an incentive for tax sheltering in agriculture. Farm Bureau policy speaks to this issue by urging the limitation of an individual's or corporation's use of the investment credit or losses incurred in one business from being used as a tax write-off in an unrelated business.

(3) REVISED TAX TREATMENT OF CAPITAL GAINS.

Farm Bureau policy states that "the tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property."

Farm Bureau supports current law with respect to capital gains treatment for sales of breeding livestock and forestry products.

Like Farm Bureau's other positions, these statements were adopted in January as singular statements of policy and not in the context of tax reform that might eliminate preferential capital gains treatment. Due to the uncertainty of the decision that the AFBF Board may make regarding capitals gains, I must limit my statement to general comments on the use of capital gains by farmers.

Under the Administration's tax plan, the livestock sector likely will be hit hard by the elimination of capital gains treatment for dairy, draft, breeding, and sporting purposes. The same is true for farmers involved in timber sales. Timber will no longer qualify for capital gains treatment.

(4) RESTRICTION OF CASH METHOD OF ACCOUNTING TO BUSINESSES: (A) WITH ANNUAL GROSS RECEIPTS OF $5 MILLION OR LESS, AND (B) WHO, OTHER THAN FARMERS, USE NO OTHER ACCOUNTING METHOD TO ASCERTAIN INCOME.

Farm Bureau supports a farmer's option to use either the cash or accrual method of accounting. The Administration's tax plan can probably accommodate the option for cash basis accounting through the $5 million ceiling and exemption for agriculture concerning alternate methods of accounting.

(5) REDUCTION IN THE DOUBLE TAXATION OF CORPORATE EARNINGS THROUGH A 10 PERCENT DIVIDEND DEDUCTION.

Farm Bureau supports a deduction by corporations for earnings distributed to stockholders as dividends and taxable in the hands of stockholders.

(6) REVISION OF ALTERNATIVE MINIMUM TAX FOR NONCORPORATE TAXPAYERS.

We support the repeal of the alternative minimum tax. Farm Bureau understands and supports the principle that taxpayers should share equitably in the tax burden. We have heard too many stories about wealthy individuals and corporations escaping taxes while those of us who are middle income taxpayers make up the difference. Farmers have experienced, however, problems with the alternative minimum tax because capital gains are considered a tax preference item which are added back into formula for computing the tax. More than one farmer or rancher has sold property and been found liable for alternative minimum tax because of the capital gains aspect. This could be a particular problem for those who are liquidating because of an existing precarious financial situation. The alternative minimum tax only worsens their situation. Because of its tendency to increase taxes inequitably for farmers who receive capital gains, Farm Bureau calls for the repeal of the alternative minimum tax.

Now, Farm Bureau would like to list for the Committee the tax reform areas where we do not now have a clearcut position, but intend to have before final consideration of tax reform. The following areas are very important to farmers and ranchers:

(1)--REPLACEMENT OF ACCELERATED COST RECOVERY SYSTEM WITH THE CAPITAL COST RECOVERY SYSTEM

(2)--REPEAL OF INCOME AVERAGING

(3)--RETENTION OF $5,000 LIMIT ON EXPENSING DEPRECIABLE BUSINESS PROPERTY RATHER THAN INCREASING TO $10,000
--REPEAL OF ELECTION TO AMORTIZE REFORESTATION EXPENDITURES
--REPEAL OF ELECTION TO DEDUCT CERTAIN SOIL AND WATER CONSERVATION EXPENDITURES, FERTILIZER AND SOIL CONDITIONING EXPENDITURES, AND LAND CLEARING EXPENDITURES

(4)--CAPITALIZATION OF PREPRODUCTION PERIOD EXPENSES

(5)--ACCELERATED EXPIRATION DATE OF ENERGY TAX CREDITS
--REVISION OF ROYALTY TAXATION
--REPEAL OF TAX EXEMPTION FOR NON-GOVERNMENTAL BONDS

(6)--REVISION OF CORPORATE MINIMUM TAX

In wrapping up, Farm Bureau will offer some comments on other issues that will be addressed during tax reform hearings:

TAX LOSS FARMING

Tax shelter activities in agriculture have generated much Congressional and media attention in recent months. Although we have endorsed no specific proposal, the legislative solutions run the gamut from a specific dollar limitation on the amount of farm losses that can be written off against non-farm income to a prorated tax benefit based upon the amount of gross income an individual receives from farming.

As previously mentioned, Farm Bureau would discourage tax sheltering activities by limiting an individual or corporation from using the investment credit or losses incurred in one business from being used as a tax write-off in an unrelated business. We oppose the use of agricultural land as a long-term, tax sheltered investment by pension and profit-sharing funds.

There appears to be an even split between those who believe that the tax code (accelerated depreciation, investment credit, capital gains) has been used to encourage agriculture tax shelters and those who believe that "real" farmers and ranchers benefit from its use. The livestock industry is an example. Some livestock producers argue that the incentives attract necessary outside capital for the industry. Other livestock producers argue that the use of tax code provisions by outside investors has led at least indirectly to lower livestock prices.

We don't believe anyone really knows the answers to these questions yet, and we encourage the development and analysis of data by the Department of Agriculture and the Department of Treasury.

Farm Bureau believes that the best cure for tax shelter activities is lower marginal tax rates which would reduce the incentive for tax sheltering.

REVENUE LOSS

Revenue loss is one of the most frequently discussed terms used in conjunction with tax policy. Farm Bureau does not want the Treasury Department to incur revenue loss; neither do we want it to incur revenue gain through tax reform.

Revenue loss is a term often glibly used by new style defenders of the federal budget. They encourage tax increases to make up for "revenue loss" associated with tax code changes. New taxes, they say, could balance the budget, eliminate the deficit, and restore America's economic soundness. Farmers and ranchers don't buy this argument. The fundamental problem, which Congress persists in maintaining, is overspending. Much of the overspending is related to the Cost-of-Living Adjustments (COLA) in federal entitlement programs. Until entitlement reform is made, our budget problems will continue. Undoubtedly, some in Congress get tired of hearing Farm Bureau's message about reducing spending to balance the budget. Mr. Chairman, we grow weary of saying it, too, but it is quite properly our top priority. Tax reform must not give way to tax increases.

TRANSITIONAL RULES, EFFECTIVE DATES, AND IMPLEMENTING REGULATIONS

Farm Bureau stresses the importance of logical, clear-cut transitional rules in a tax reform package. The switch from the current system to a new one will be nightmarish at best. Congress must be careful to draft the best transition rules it can with reasonable effective dates. Congress should emphasize to the Treasury Department and Internal Revenue Service the importance of preparing understandable implementing regulations. It will defeat the Administration's goal of simplicity if the tax code is simplified, but the regulations continue to be written with unnecessary complexity and verbiage.

DEDUCTIBILITY OF BUSINESS EXPENSES

Farmers and ranchers are concerned that expenses incurred in their trade or business remain deductible. Business interest, state and local property taxes, employment taxes, and various sales and excise taxes are costs of doing business that must remain deductible. We understand that such expenses are deductible under the Administration's plan, and urge the Committee to clarify this during any mark-up session.

HEALTH INSURANCE TAX DEDUCTION

As we have advised the Committee before, farmers and ranchers are keenly aware of an inequity in the tax code that has become more acute in recent years of rising health insurance costs.

The fringe benefit section of the plan causes us to focus attention on an inequity that exists because self-employed sole proprietors, including 88 percent of the nation's farmers, cannot deduct their health insurance costs as an ordinary and necessary business expense. However, when employers furnish health insurance for their employees, the full cost of the coverage is deductible to the employer as a business expense (IRC 162) and is tax free to the employee (IRC 106). This inequity in tax treatment is not justified, and Farm Bureau urges you to support reform that would help eliminate the inequity.

Senator Chuck Grassley (R., Iowa) and Representative Del Latta (R., Ohio) have introduced S. 419 and H.R. 11 that would permit a self-employed individual to deduct one half of his or her health insurance premium as a business expense. We believe this approach is reasonable because a self-employed person has characteristics of both an employer and an employee through the contribution of capital and labor. S. 419 and H.R. 11 currently have 25 co-sponsors and 173 co-sponsors, respectively. Our members have made enactment of this legislation a priority issue.

Farming is the most dangerous occupation in the country, and Farm Bureau considers the health insurance cost as an ordinary and necessary business expense. We recognize that the base broadening argument may work against this type of deduction, but the inequity that exists for self-employed farmers who are paying several thousand dollars per year for health insurance adds significantly to our cost of doing business. Equity dictates relief for the self-employed.

SOCIAL SECURITY TAXES

We understand that one effect of any attempt to broaden the income tax base through the elimination of certain deductions would be an increase in Social Security taxes for the self-employed. With a self-employment tax rate of 14 percent on a wage base of $39,600, we must raise an objection to this provision. The effects of tax reform on employment taxes has not received much attention, and we strongly urge the Committee to examine this area. Higher employment taxes are a disincentive to private initiative. This type of provision could drive more people into the underground cash economy rather than bring them into the daylight of the taxpaying public.

* * *

As Farm Bureau concludes its testimony, we reaffirm our commitment to tax reform that is revenue neutral and insures that farmers and ranchers are treated fairly. Tax policy is as important to us as farm policy because it has critical implications for farmers both on an individual and a business basis.

We recognize that in some deliberations the goals of economic growth, equity, simplicity, and revenue neutrality may seem to work at cross purposes. For example, Farm Bureau calls for the elimination of Form 1099 or in the alternative to increase the reporting level from $600 to $5,000. The goal of the requirement is fairness -- to make sure that people report their income. We, on the other hand, have viewed the form and its penalties for failure to file as an administrative irritant. Thus, principles of tax reform must be balanced. We commend the Committee for its attempts to balance these goals and to hear testimony from all sides during these hearings.

Farm Bureau will do its best to assist you in your deliberations. As soon as the AFBF Board of Directors makes its decision in August, we will so advise you and file an addendum for inclusion in the hearing record.

Thank You.

AMERICAN FARM BUREAU FEDERATION 1985 INCOME TAX POLICIES

Tax policy should be designed to encourage private initiative, economic growth, equity, and simplicity.

Farm Bureau supports:

(1) Income tax indexing;
(2) Reductions in tax rates;
(3) Preservation of the confidentiality of federal income tax returns;
(4) A flat rate income tax or a modified flat rate income tax based on net income that is revenue neutral. Farm Bureau will protect the interest of farmers to ensure that agriculture is treated fairly in this or any other tax change;
(5) A 10-year carryforward for disaster losses;
(6) A farmer's option to use either the cash or accrual method of accounting;
(7) Repeal of the alternative minimum tax;
(8) Repeal of the requirement for farmers to file 1099 forms; otherwise, an increase in the reporting level from $600 to $5,000;
(9) A deduction by corporations for earnings distributed to stockholders as dividends and taxable in the hands of stockholders;
(10) Elimination of the imputed interest rate provisions of the Internal Revenue Service (IRS) code;
(11) Limiting an individual or corporation from using the investment credit or losses incurred in one business from being used as a tax write-off in an unrelated business; and
(12) A federal tax amnesty program with the yield of such a program to be applied against the national debt.

Farm Bureau opposes:

(1) A freeze or cap on scheduled tax cuts;
(2) Income tax withholding from farm workers' earnings;
(3) The taxing of interest income as it accrues;
(4) The use of agricultural land as a long-term, tax sheltered investment by pension and profit-sharing funds; and
(5) The mandatory requirement for a mileage log on farm vehicles as required by the IRS beginning January 1, 1985.

We urge the IRS to abide by the decisions of state and local officials as to which agricultural lands shall be preserved in farm use through use of tax-deductible contributions of voluntary, private conservation easements.

We believe the Internal Revenue Code (Sec. 163) should be amended to permit farmers and ranchers, whether on cash or accrual basis of accounting, to deduct interest payments on farm loans as an expense item whether the interest payment is made with funds obtained from the original creditor through a second loan, an advance or other financial arrangement similar to a loan or from funds secured from a second creditor.

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SUMMARY OF OTHER AFBF 1985 TAX POLICIES

SALES AND EXCISE TAXES

Farm Bureau supports:

(1) Reserving the retail sales tax for state and local governments.

(2) Limiting federal excise taxes to nonessentials and user taxes.

(3) The exemption of agricultural aircraft fuel from federal airport and airway taxes.

(4) The removal of the excise tax on sales of wellhead oil.

Farm Bureau opposes:

(1) Any additional tax on any farm commodity.

(2) The adoption of a federal value-added tax.

CAPITAL GAINS

Farm Bureau supports:

(1) Retention of the present minimum holding period.

(2) An exemption from the capital gains tax when a farm is sold and another farm purchased within 18 months after the original sale.

(3) The present law with respect to capital gains treatment for sales of breeding livestock and forestry products.

(4) Legislation that would reduce capital gains taxes for retiring farmers who sell their farms to farmers and finance the farms themselves.

(5) Requiring that foreigners pay capital gains taxes when their land holdings are sold.

Farm Bureau opposes proposals to apply the capital gains tax to the appreciated value of property transferred by reason of the death of the owner.

FEDERAL ESTATE TAXES

Farm Bureau supports repeal of federal estate taxes.

STATEMENT OF CAL COULTER, VICE CHAIRMAN, TAX AND FINANCE COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION, BRIDGEPORT, NE

Mr. COULTER. Mr. Chairman and gentlemen of the committee, my name is Cal Coulter. I am a rancher from western Nebraska. I live on a ranch and, unfortunately, in this day and age, I have no other outside income. Since the time is limited, I will skip a number of items that you will find in my written statement that has been submitted to the committee and try and concentrate on the portions of the proposal which we find unacceptable or very difficult for the livestock industry to support. I am here today on behalf of the National Cattlemen's Association, and I do serve on their tax committee. The first thing that we find to be extremely difficult is the unavailability of the expensing of the preproductive expenses. Those are important to us. They are as important to us, perhaps, as they are to the timber industry, but the same general principles apply. We have an added problem and that is the accounting that would be required if we were to capitalize those expenses.

Please do not require small farmers, cattlemen, people who do not have the capability to become accountants. We already have enough problem producing our product. I don't think you want to keep milk cows and chickens in your backyard, and we don't want to have to become accountants. And that is kind of what we are talking about here. The yield to Treasury would probably not be significant if we had to capitalize those expenses, particularly in a cow herd where there is a regular program of retaining heifers every year for breeding purposes. That, over a period of time, tends to have exactly the same effect, and the accounting difficulties with capitalization of these preproductive expenses would be horrendous for us. The second thing that is important to us is the capital gains treatment on the breeding herd. To remove this, particularly at this time when there is a great deal of stress in agriculture, when there are some herd liquidations going on in my county today where we are suffering a severe drought—a large grasshopper population—there are many cattle moving out of my area. Also, the adjoining States—western Dakotas, Montana, Wyoming. These cattle are being forced into liquidation. That is going to create a tax problem. If the capital gains treatment were denied, it would create an even greater tax problem. And the tax problem is being created for people who are suffering a loss, who have suffered a loss for a number of years, and who are losing their ranches and their farms. Please don't compound that problem by removing the capital gains treatment for livestock. We have that treatment under a special section, and if that were eliminated, we are fearful that general sections on capital gains might not apply. Another item that is relatively small but very, very important is the expensing of soil and water conversation expenses. The proposal that we have seen would tend to deny that. Those would have to be capitalized over the useful life of the improvement. Many of these are temporary. They would not be recovered at the time the land was sold eventually. I think it is very important not only to the person who owns the ranch or the farm, but it is also very important to the stewardship of that land that we encourage soil conservation. And those expenses should be allowed to be deducted in the year in which the expenditure is made. They are not generally income-producing expenditures. They are things that are good for our industry and good for that land, and we ought to use every means we can to encourage them. The fourth thing that is extremely important to us is cash basis accounting. We have already been through that several times this morning, but again, we get back to the problem of whether we are going to be accountants or whether we are going to get out there and produce the food and the fiber that this nations needs. Cash-basis accounting is a very simple, fairly accurate, manageable tool that we use in our industry. There has been a USDA study in the sometime recent past that would indicate that perhaps 90 percent of the people involved in agriculture production use cash-basis accounting. I am sure that the numbers in terms of dollars and in terms of product would not reflect that same ratio, Many of the large producers may have the capability to use accrual-basis accounting. Most of us not only prefer but probably don't even have the capability to use anything except cash-basis accounting. I think that it would be helpful if we would realize that this should be a tax proposal not from the President or not the present code, but a tax proposal written by Congress with the input from everybody so that we don't have to prejudice the result based on who made the proposal. I would hope that we could make some progress in this area, that we could come up with something that was helpful that would be simpler that we could all live with and would-be beneficial. Thank you.

The CHAIRMAN. Thank you. Mr. Hassebrook.

[The prepared written statement of Mr. Coulter follows:]

Testimony on Behalf

of the

NATIONAL CATTLEMEN'S ASSOCIATION

on
Tax Reform

before
Chairman Bob Packwood and the
Finance Committee

submitted by

Cal Coulter, Vice Chairman
NCA Tax and Finance Committee

July 10, 1985

Mr. Chairman, and members of the Committee, my name is Cal Coulter. I am a rancher from Bridgeport, Nebraska and Vice Chairman of the National Cattlemen's Association Tax and Finance Committee. I am pleased to be here today and would like to share with you the NCA's opinions and recommendations on tax reform. The National Cattlemen's Association represents over 200,000 farmers and ranchers nationwide through direct membership in our association and affiliated state associations.

My ranch is located in Western Nebraska and I have been actively farming and ranching all my life. As you know, agriculture and the cattle industry are currently undergoing some very difficult and trying economic times. As cattlemen and businessmen, we recognize the importance of a fair and equitable tax code, which promotes growth and good economic business decisions.

OVERVIEW OF TAX REFORM

The numerous tax reform proposals, including President Reagan's recent proposal, all broaden the tax base and then reduce marginal tax rates. This type of reform is desirable and definitely a move in the right direction. Simplifying the tax code is desired by every taxpayer and business. We support the efforts of the Administration and Congress to attempt to bring order to the complex tax code that has evolved over the years.

High interest rates, fluctuating cattle prices and the strong dollar have hurt agriculture and the cattle industry in recent years. We are seeing heavy liquidation of beef cattle and all of agriculture is under financial pressure. Our business is capital intensive and acquisitions are primarily financed through debt.

Agriculture needs equity capital, not debt capital, and the equity investment must be based on economic returns. Equity capital will help farmers and ranchers across the country. We are concerned that adequate capital be available to finance our operations. Economic growth must continue to be a primary objective as you progress down the road to tax reform.

Fairness is the "key" to tax reform and must govern changes in the tax code. Our membership readily accepts and desires changes which make the tax laws fairer and are aimed at treating all industries and individuals equitably. Fairness should be the number one goal of Congress.

NCA has expressed strong support for broad-based tax reform that treats all segments of our economy equally. We urge that no particular industry be singled out and targeted for specific changes treating a perceived symptom. For example, changes which try to limit deductibility of farm losses without regard for the source of the loss are near sighted and do not address the provisions in our tax code that underlie the problem.

FAVORABLE REFORM PROVISIONS

Lower marginal tax rates create an economic incentive and are a desirable result of tax reform. NCA fully supports efforts to reduce the number of tax brackets and to lower tax rates. We believe lower marginal rates will reduce the incentive for taxpayers to seek out tax-shelters and stimulate cattlemen to make decisions based on economic rationale and not based on tax considerations alone.

Furthermore, increasing the personal exemption level for individuals, as well as the zero bracket amount, contribute significantly to a fairer and more equitable system. Cattlemen support these efforts and hope the Committee will include such provisions in a reform proposal.

CONSTRUCTIVE REFORM

Tax Shelters

NCA recognizes and supports efforts to address the tax shelter problems that occur in agriculture. As I mentioned earlier in my remarks, NCA wants investment in the cattle business for economic reasons--to make a profit--and not simply based on tax considerations.

Investment Tax Credit

In the interest of obtaining fair tax reform and lower tax rates, we can accept elimination of investment tax credit in the President's package. Cattlemen do utilize ITC in their operations, but we will accept the repeal of ITC if it results in a fair tax system where investment is made for economic reasons.

Depreciation

NCA supports a depreciation system that more accurately reflects the economic useful life of a particular asset such as a cow, pickup or tractor. President Reagan's proposed Capital Cost Recovery System appears to fairly reflect useful life and reasonable economic depreciation. In addition, the proposed CCRS accurately reflects the true depreciation value by indexing for inflation. We urge the Ways and Means Committee to include a depreciation system like CCRS in the tax reform bill.

Income Averaging

One other area I would like to touch on is income averaging. As I noted earlier today, the cattle business and, really, agriculture in general is a highly volatile industry. Net income from farming and ranching can fluctuate 100% from year to year. Lower marginal tax rates will offset some, but not all of the impact of repealing income averaging. We remind you that this provision has been a useful tool for agricultural producers, along with cash accounting, to moderate the peaks and valleys in income.

UNACCEPTABLE REFORM PROVISIONS

Several areas of the various tax reform proposals are cause for substantial concern in the cattle industry. We realize the need to lay these concerns on the table and will do so today. Some of our problems with the President's proposal can be rectified with minor technical changes and others will require modifications based on fairness. We feel it is important to outline our concerns today and then to work with you, the Ways & Means Committee, the Administration, and other agricultural organizations to achieve a fair and equitable tax bill.

Multiperiod Expensing

At the top of our list, is a concern over a provision in the Administration's proposal on preproductive period expenses. The President's proposal requires all expenses (other than interest and taxes) associated with the production of replacement heifers to be capitalized if the preproductive period exceeds two years. The two-year period begins when the heifer is conceived and ends when she is placed in the breeding herd. Cattlemen normally place the heifers back in the herd at fifteen to eighteen months of age, so when you consider the nine-month gestation period, essentially all farmers and ranchers will be required to capitalize expenses. This produces an accounting nightmare for cattlemen, and literally forces them to switch to some sort of hybrid accrual method of accounting.

In addition, cattlemen could be forced to make a noneconomic decision, either capitalize expenses on raised replacement heifers or purchase heifers to avoid capitalization. This places an unreasonable burden on cow/calf producers and violates the objective of fairness in tax reform. It is incongruous that a tax reform proposal would encourage an uneconomic decision to purchase breeding cattle to avoid the accounting nightmare.

CAPITAL GAINS

NCA opposes the elimination of capital gains treatment for Section 1231, assets which includes breeding livestock. Elimination of capital gains tax treatment on income from the sale of breeding livestock doubles the burden on the cow/calf producer. A cow, which is held as a capital asset to produce calves as ordinary income, is similar to a factory and should be eligible for capital gains treatment. Congress has long recognized a distinction for capital assets, such as breeding livestock, as opposed to business property held for sale. We feel our industry was unfairly targeted in the President's plan.

SOIL AND WATER CONSERVATION

Another area of concern to cattlemen is the elimination of immediate deductibility of soil and water conservation costs. As stewards of the land, farmers and ranchers must continually practice soil and water conservation measures to maintain their production base.

All soil and water conservation improvements are not the same. For example, fertilization, brush control, and seeding of waterways are recurring expenses with little carryover and should be expensed.

Improvements that are not permanent to the land should either be currently deductible or depreciated over a relatively short period. The President's plan would require the expenditures be added to the basis of the land; consequently, a farmer who builds a stock pond that lasts fifteen years before it fills with sediment, must build another pond. Under the President's proposal, the costs associated with building that first pond would not be depreciable; instead, these costs would be capitalized into the basis of the property

NCA strongly urges the Finance Committee to draft provisions that appropriately reflect the nature of the soil and water conservation expenses.

CASH ACCOUNTING

Most farmers currently use the cash method of accounting in their operations. The ability to deduct expenses as incurred and account for income as it is actually received serves as important and useful management tool for cattlemen. Fluctuation in prices, weather, interest rates and other factors create cycles of farm income and farm losses that are moderated under cash accounting.

The President's proposal places a limit on the availability of cash accounting to those farmers and ranchers whose operations create less than $5 million in gross receipts. NCA feels this is an arbitrary level that fails to consider the type of farming operation and makes no distinction or reference to livestock versus crops or permanent versus annual crops. We urge Congress to remove such an arbitrary cap and to permit farmers and ranchers to continue using the cash method of accounting if they choose. Congress should not dictate a method of accounting and avoid drafting such provisions that have little relation to the nature of a particular business.

OBTAINING A TAX REFORM BILL

We want to work with both the Finance Committee and Ways & Means Committee to obtain a fair tax reform bill. We are encouraged that partisan politics will be left on the sidelines and Democrats and Republicans will work together.

NCA has some concerns with President Reagan's proposal, but we realize it is just one of several proposals you will consider. We want to work closely with you to draft a tax reform bill that is fair to everyone.

AG TAX STUDY GROUP

Early this spring, NCA organized and initiated a forum for agricultural groups to meet and discuss tax issues. This tax study group has evolved into a very useful forum for educating, discussing and planning. Obviously, all of agriculture is not affected by tax reform in the same way.

The agriculture tax study group will continue to meet over the next few months to discuss differences, similarities and overall impact on particular segments of agriculture and the industry as a whole. The working group of 15 to 20 agricultural groups will be happy to work with the Finance Committee to discuss different ideas and proposals and impact of those proposals on various segments of agriculture.

SUMMARY

NCA supports fair, equitable tax reform that attempts to simplify the tax code and yet maintains incentive for economic growth. Cattlemen want to work with you to ensure that our concerns on preproductive period expensing, capital gains on breeding livestock, expensing of soil and water conservation and the limitations on cash basis accounting are addressed in a fair and equitable manner.

Tax shelters have been a concern in our industry as well as other industries because of tax code problems. We feel lower marginal tax rates, repealing investment tax credit and adoption of a depreciation system that more accurately reflects useful life, removes the major incentives for seeking tax shelters in agriculture. Cattlemen support those measures which are broad-based solutions to a problem and are not targeted at specific industries.

Chairman Packwood, and members of the Committee, we recognize the difficult deliberations that confront you as you attempt to reform the tax code to make it fair, simple and yet maintain incentive for growth. However, cattlemen encourage you not to lose sight of a very worthwhile and desirable goal. NCA will be an active organization in tax reform and will do so in a very positive and constructive manner; after all a fair tax code is our goal, too.

STATEMENT OF CHUCK HASSEBROOK, TAX POLICY ANALYST, CENTER FOR RURAL AFFAIRS, WALTHILL, NE.

Mr. HASSEBROOK. My name is Chuck Hassebrook. I represent the Center for Rural Affairs, which is a family farm research ar advocacy organization at Walthill, NE. I appreciate the opportunity to testify and your kind invitation and introduction, Senator Exon. I want to say some things that you don't hear very often here, and that is that I think we in agriculture, particularly small farmers and family sized farmers, would be better off without a lot of these tax breaks. And the reason is that I think we have made farming a tax shelter industry in this country, and with that have come some very negative results. One of the results is that we attract overinvestment in agriculture with the tax shelters; and we get more production than we can sell to profit and we get low profits. We get the problems we are having today. And the other is that when we make agriculture a tax shelter, we change all the rules of competition, and suddenly, it is not enough to produce efficiently to compete in agriculture today.

It is a tax shelter, and to compete in a tax shelter industry, you have to be able to exploit the tax shelter as effectively as your competitors. And as a consequence, the tax rules and the tax preferences in agriculture today are undermining some of the most efficient, moderate-sized, and beginning farmers we have that don't have the incomes and the capital to effectively exploit the tax shelters. I want to run through a few quick examples—a couple of examples—to illustrate what I say. The first one concerns the treatment of single-purpose structures—hog confinement buildings, poultry confinement buildings, dairy buildings, and what have you. The treatment of those buildings as equipment since the late 1970's—basically means they are eligible for the investment credit and a 5-year rather than an 18-year depreciation. In the hog industry, in 4 out of 5 years following the adoption of those tax-shelter provisons for single-purpose structures, hog producers lost money. In 2 of those years, we lost 30 percent of the Nation's hog producers to low profits. Yet, in 1984, in spite of those very low profits and hard times for some people out in the hog industry, six corporations found it to their benefit to come into the hog industry in a very large way that would add over 1 million hogs per year to the market. Now, those six corporations, on average—those types of operations on average—benefit about 2½ to 7 times per unit of production from the tax preferences we are talking about over average family farmers. And those family farmers—that additional production of just those six corporations—will cost them $2,000 to $3,000 a year in lost profits because of the lower price, which is substantially more than they gain from the tax break. What we have done is change the rules of competition, brought in the overinvestment, and lost the profitability. I think it is also worth noting that this not only hurts family farmers; it hurts the economy. According to University of Tennessee research, the very capital intensive hog operations that are favored by this provision; encouraged and subsidized; are less efficient than more moderate investment and higher labor enterprises. The Reagan plan would perpetuate this tax shelter. Confinement buildings would still be defined as equipment, and we urge that they be put in the structure category—either the one in the bill or a modified category—maybe somewhere along the lines of the current 18-year depreciation for structures. I want to talk also about the favorable tax treatment of breeding stock, and it is very favorable. Many farm lawyers have gotten in the habit of calling this provision the farmer's friend, but I would call it the family farmer's foe frankly. Now, what the rule basically says is that if you raise your own breeding stock, you deduct 100 percent of the cost of raising that animal. When you sell it, you count only 40 percent of the sale price as income. So, in every breeding animal in the herd, we create artificial losses for tax purposes, and that means that every breeding animal in this country has become a tax-shelter investment. And what are the results? The University of Nebraska told hog producers in the late 1970's that is was more efficient if they kept their sows—in other words, their female swine breeding stock—to keep those sows for four litters. That is more efficient, but if your tax bracket is 35 percent or more, you should keep your sows for only one litter because the greater tax savings from the capital gains exemption would more than make up for the inefficiency. We subsidize inefficiency to capture the tax benefit of this provision. I think the other result is low profitability. If you look at the dairy industry, for example, we are struggling with overproduction of milk products, but yet we encourage more investment and more expansion of the herd in the dairy industry by tax sheltering in dairy cows. The cow-calf industry is very heavily affected by this. The cow-calf industry has become known—I have heard the term applied to the cow-calf industry as the "industry that lives on losses." And I think if we want to understand why, we have got to look at the tax laws that make that industry a tax shelter and encourage the overinvestment and overproduction that eliminate the profitability. Now, I support the President's proposal on preproductive development expenses. I think it would eliminate the shelter and avoid some of the excessive recordkeeping that Treasury I would have had. And we also support the capital gains provison—that is, to eliminate capital gains on breeding stock sales. And I might add that we ran some analyses, and for the average farmer or rancher who would be in the 15-percent bracket under the President's proposal—and I am summarizing quickly—a small 1.5-cent-per-pound price increase would more than make up for that. And of course, for higher bracket producers who now have an unfair advantage, it would take a lot more than that. In summary, we support parts of the President's proposal. Our only disappointment is that we don't think it went far enough in eliminating tax shelters; and as a consequence, we have a problem with deficits because we are keeping too many tax shelters. I have some more recommendations in the testimony. Specifically, I would like you to take a look at the recommendations for putting some further restrictions on the use of cash accounting in farming. Thank you.

The CHAIRMAN. Thank you. Mr. Hanson.

[The prepared written statement of Mr. Hassebrook follows:]

STATEMENT OF CHUCK HASSEBROOK
CENTER FOR RURAL AFFAIRS, WALTHILL, NEBRASKA
ON THE IMPACT OF THE PRESIDENT'S TAX PROPOSAL ON AGRICULTURE

I appreciate the opportunity to speak with you today about tax policy and agriculture. I am the tax policy analyst at the Center for Rural Affairs, a Nebraska based private, unaffiliated family farm research and advocacy organization governed by a board of Nebraska farmers, ranchers, academics, clergy and small business people. My principle message today is that fundamental tax reform is critical if profitability and stability are to return to American agriculture and if farm opportunity is to be available to more than a privileged few. I praise the President's proposal where it eliminates tax shelters and preferences, and criticize it where it does not. I include recommendations at the end of my testimony. Our more detailed analysis of the impact of the proposal on agriculture is appended.

FAMILY FARM AGRICULTURE REQUIRES TAX REFORM

Family farmers are questioning and increasingly opposing their tax breaks, reflected in resolutions passed by local chapters of the Farm Bureau, Farmers Union, National Farmers Organization, Grange and Pork Producers Association. The family farm cannot survive in a tax shelter economy. Tax incentives have stimulated overproduction, lowering farm profits and raising farm program costs. Tax subsidies for farm enlargement and replacement of labor with capital have fostered the concentration of agriculture in fewer hands, at the expense of efficient moderate-sized and beginning farmers. Inefficient practices have been adopted to maximize tax benefits. Efficiency is being eclipsed by ability to exploit tax shelters as the rule of farm competition. Moderate sized and beginning farmers whose moderate incomes and modest investments do not allow them to reap bumper crops of tax savings, are placed at a competitive disadvantage.

To foster farm opportunity and efficiency, the tax code should be progressive and free of tax shelters, such as the initial Treasury proposal. The president's proposal is a disappointing step backward from that beginning. By reducing the effective progressivity of income taxation, it would provide for greater concentration. And by preserving the largest tax shelters, it would continue much of the inefficiency, distortion, and unfair competition wrought by the existing code. Nonetheless, it would eliminate some harmful tax shelters and improve profitability and opportunity in some sectors of agriculture.

FARM TAX SHELTERS ELIMINATED BY THE PRESIDENT'S PROPOSAL

Elimination of the capital gains exemption on breeding stock would end the inefficient but tax subsidized practice of keeping swine breeding stock for only one litter. It would improve profits. The capital gains exemption makes every dairy and breeding animal a tax shelter and is a direct invitation to chronic overproduction. A calf price increase of $1.50 per hundred pounds would more than make up for loss of the proposed 50 percent capital gains exemption for a 15 percent bracket rancher. That, together with a nine cents per hundred pounds milk price increase, would recover the savings lost to average milk producers. Thirty five percent bracket taxpayers would need three times those increases to recover their lost tax savings and the advantage they are granted over moderate income farmers and ranchers.

Requiring addition of beef and dairy stock to inventory, if they are to be deducted, would improve profits and return some fairness to the arena of farm competition. Current law effectively provides that income invested in expansion of the breeding herd is entirely exempt from taxation; a direct invitation to chronic overproduction and low profitability. The proposal avoids the excessive record keeping that would have resulted from Treasury I, which required that costs of raising replacement stock be separated from costs of raising all other calves.

Ending deduction of land clearing and leveling costs would reduce long-term grain surpluses and soil erosion. The land clearing deduction typically subsidizes conversion of woodlands to cropland by high bracket taxpayers by $150 per acre. In the Nebraska Sandhills, developers who knock down sandy ridges to allow farm equipment to pass over deduct the cost of denuding the land as a conservation expense. However, as the president's proposal would eliminate this abuse it would also eliminate the deduction for true conservation investments such as terraces. That would increase the cost of soil conservation and lead to more soil erosion.

HARMFUL TAX SHELTERS RETAINED BY THE PRESIDENT'S PROPOSAL

The capital cost recovery system would deliver greater subsidies than the current depreciation system. In fact, if inflation rises to ten percent the value of depreciation deductions on a farm tractor owned by a 35 percent bracket taxpayer would be greater than depreciation and the investment credit combined under current law. The shift to subsidizing capital investment through more lucrative depreciation deductions which rise in value with the tax bracket, instead of the investment credit, would widen the disparity between tax benefits to low and high bracket farmers.

Placement of single purpose agricultural structures in the equipment depreciation category would have a particularly severe impact on the hog, poultry and dairy industries. This misclassification already exists in current law and has brought chronic over production, low profitability, tax shelter investment, and concentration to these sectors. To a top bracket investor, the classification of hog buildings as equipment in the capital cost recovery system would be worth $140 per sow (breeding hog) capacity; two and one half to seven times the benefit to typical farmers. This would be bad for the economy as well as family farmers. The capital intensive production systems which would be encouraged by this provision are less efficient than moderate investment systems. Capital would be drawn away from sectors where it is needed and can be used productively.

Several other tax shelters would continue to foster farm concentration and undermine farm profitability under the president's proposal. Cash accounting would continue to grant a competitive advantage to high income, large farms and finance the movement of the cattle feeding industry into the hands of tax shelter investors. The opportunity to deduct more than the real cost of borrowing money would continue to grant negative after tax real interest rates to high income investors, while most family farmers and small business people struggle with record real interest rates. The capital gains exemption would continue to favor income received by land speculation over income earned by farming and put moderate income farmers at a competitive disadvantage in the land market. The capital gains of corporations and families who grow wealthy on large landholdings held or given to heirs would not be taxed. So the tax favored growth of a landed gentry would continue. The low tax rates on the first $75,000 of corporate income would eliminate the progressivity of farm taxation and foster concentration. High income owners of large farming operations would divide income between employee stockholders and the corporation, which would both enjoy low tax rates. Income averaging would be abolished to recover revenue lost to tax shelters, placing inequitable tax burdens on farmers and small business people with volatile incomes.

RECOMMENDATIONS

Place single purpose agricultural structures in the structure depreciation category

Retain the deduction for conservation expenses, but define eligible investments narrowly to include only those which reduce soil erosion

For taxpayers using cash accounting, limit deduction of costs of inputs for use in following years to 25 percent of such inputs used, or the national median income, whichever is less. Limit deduction of farm losses from nonfarm income.

Adopt the President's proposals to eliminate the investment tax credit, capital gains treatment of breeding stock/depreciable property, and land clearing deductions.

Adopt the president's proposal to allow deduction of costs of raising orchards, dairy cows, and breeding cattle only if they are added to inventory, but scrutinize transition problems for farmers and ranchers who could face large tax bills on prior year's income

Adopt the Treasury I proposals on depreciation, interest indexing, elimination of graduated corporate tax rates, and capital gains.

Tax individual capital gains at death and corporate gains at regular intervals.

Allow income averaging by taxpayers with volatile incomes but end its use by those with rapidly rising incomes

STATEMENT OF ROBERT A. HANSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, DEERE & CO., MOLINE, IL

Mr. HANSON. Good morning. I am Robert Hanson, chairman and chief executive officer of Deere & Co. I also have with me, Mr. Bernard Hardiek, the tax director of Deere & Co. Thank you for the opportunity to present our company's views on the impact of President Reagan's tax proposals on agriculture.

The name John Deere has been associated with quality farm equipment for 148 years. Our company's past and our future are tied closely to the American farmer and the farm economy. All of you are aware that farmers and farm equipment companies have faced very difficult times during the long recession in the farm economy. The farm equipment industry, which lost over $4 billion in the last 5 years, now employs only half of the 160,000 people it employed in 1980. Several long-time farm equipment manufacturers, such as International Harvester, are no longer in the farm equipment business today; and many long-time farmers have lost the farms that they and prior generations had worked long and hard to acquire.

While Deere & Co. is concerned that the repeal of the investment tax credit will increase its cost of capital goods and make us less competitive with foreign manufacturers, our principal concern is the impact upon the farmer and the farm economy. Our analysis indicates that the typical farm operator's income taxes will be substantially increased if the President's tax reform plan is enacted. The principal reason for the adverse impact on farmers is the proposed repeal of the investment tax credit. In order to determine the impact of the President's tax proposal on farmers, we have utilized the 60 years of experience of the University of Illinois College of Agriculture in analyzing the operations of some 7,977 farms located in the State of Illinois.

We obtained average income and farm equipment investment figures from the University of Illinois farm records and prepared a computation of a typical farm operator's income tax under current and proposed tax law. That calculation is shown in the last page of my written statement, which has been submitted for the record. This computation shows that a typical farm operator's income tax would increase by over $900 a year under the President's tax reform plan. This $900 increase in tax considers the combined impact of the increased deduction for personal exemptions, the lower tax rates, and the proposed repeal of the investment tax credit. It should be noted that, unlike other studies which define and include as farmers anyone having over $1,000 in gross receipts from the sale of farm products, this study includes primarily farm operators who earn most of their income from farming and are typical of the farmers who produce the majority of this Nation's farm crops. Based upon the U.S. Department of Agriculture data on investment in farm equipment, the University of Illinois farm operator's data and our calculation of tax under current and proposed law, we estimate that the repeal of the investment tax credit would increase the Federal income taxes of all U.S. farmers by approximately $970 million, while the increase in the deduction for personal exemptions and the lower tax rates would decrease their taxes by $380 million. The net result is an increase in the farmers' tax burden of $590 million—a very major increase.

The adverse impact of the President's proposed tax program would create a substantial additional cost burden for farmers who are still enduring one of the longest farm recessions in history. In addition, pending farm legislation may result in a substantial reduction of Federal assistance for agriculture under farm commodity support programs. Should such legislation be enacted, this would cause the impact of the repeal of the investment tax credit to be felt even more keenly than would otherwise be the case.

In summary, Mr. Chairman, the repeal of the investment tax credit would increase the income tax burden to the farm sector by an estimated $590 million per year at a time when the farm economy is in a deep recession. Some farmers are losing their land, and farm legislation may reduce Federal assistance substantially. While Treasury estimates that almost 80 percent of the individual taxpayers will pay less tax under the President's proposed tax bill, the typical farmer will pay over $900 a year in additional taxes. Therefore we urge you to retain the investment tax credit, at least as it relates to the typical farm operator who raises the major portion of our Nation's crops and livestock. We appreciate the committee's time and attention and wish you success in your difficult deliberations. We would be glad to respond to any questions you may have. Thank you.

The CHAIRMAN. Thank you, sir.

[The prepared written statement of Mr. Hanson follows:]

STATEMENT OF ROBERT A. HANSON, CHAIRMAN OF DEERE & COMPANY, BEFORE THE SENATE FINANCE COMMITTEE HEARINGS ON PRESIDENT REAGAN'S TAX PROPOSALS

WEDNESDAY, JULY 10, 1985

I'm Robert Hanson, Chairman and Chief Executive Officer of Deere & Company. Deere manufactures and markets a full line of agricultural, industrial and lawn care products. Deere & Company currently employs over 42,000 people, is ranked 86th on the Fortune 500 list and had sales of 4.4 billion dollars last year. Our world headquarters are located in Moline, Illinois. I appreciate the opportunity to provide this committee with Deere & Company's comments on the impact of President Reagan's proposed tax reform on agriculture.

Farmers and farm equipment manufacturers have faced difficult economic times during the long recession in the farm economy. The farm equipment industry, which incurred over four billion dollars in losses since 1980, now employs 80,000 people compared to 160,000 people in 1980. During the last few months we have seen several long-time farm equipment manufacturers announce their intention to discontinue the manufacture and sale of farm equipment. We have also seen many long time farmers go out of business or incur a substantial deterioration in their financial health.

While Deere is concerned that the repeal of the investment credit will increase our cost of capital goods and make us less competitive with foreign manufacturers, our principal concern is the impact upon the farm economy. When the President announced his tax reform proposal in late May, we at Deere & Company quite naturally asked ourselves what the combined impact of the higher personal exemptions, the lower tax rates, and the loss of the investment credit would be on our farm customers. Our analysis indicates to us that farmers will be adversely affected by the President's tax reform program. The principal reason for the adverse impact on farmers is the repeal of the investment credit. While the increase in the deduction for personal exemptions and the lower tax rates will help to reduce the farmer's tax, this benefit is more than offset by the loss of the investment credit.

I would like to take a moment to explain to this committee how we arrived at our findings. Since the University of Illinois College of Agriculture has been active in the collection of data and analysis of farm income and expenses we sought advice and information from them. The University of Illinois and the Illinois Farm Bureau Farm Management Association have 70 full time field staff who keep farm records for 7,977 farms located in Illinois. The farm record project includes the operations of small, medium and large farms. The University of Illinois has been collecting and analyzing this farm data for over sixty years and each year publishes financial information gathered from these records. We have used the farm income and capital purchases for the years 1981 thru 1984 to determine the impact of the proposed tax reform on a typical farmer.

Our calculation of the impact of the proposed changes on a typical Illinois farm operator is included as Exhibit A, the last page of my testimony. As you will see, tha net farm income and the non-farm income total $20,576. This is shown on Line 3. These amounts were calculated by averaging the 1981 thru 1984 amounts earned by Illinois farm operators whose records were maintained by the Illinois Farm Bureau

Farm Management Association and which were reported in the University of Illinois' Summary of Illinois Farm Business Records. Line 6 shows the increase in the deduction for four personal exemptions from $4,000 to $8,000 under the proposed law. Line 8 shows that the tax before credits is reduced from $1,863 to $1,286. However, line 9 shows that the repeal of the investment credit will cost the farmer $1,479. We determined from the University of Illinois Farm Business Records report that, based upon data from the years 1981 thru 1984, an Illinois farm operator's average purchase of farm equipment was $14,790 per year. This purchase results in an investment credit of 10% of $14,790 or $1,479. Line 10 is the farmer's bottom line on income taxes. Under current law he is required to send the IRS a check for $384. Under President Reagan's proposal he will have to send the IRS a check for $1,286 - three times his tax under current law. We believe that this example is typical of the impact that the proposed tax law would have on most farm operators since it is based on information derived from actual farm records of almost 8,000 farms. It should be noted that unlike other studies which define and include as farmers anyone having over $1,000 in gross receipts from the sale of farm products, this study includes primarily farm operators who earn most of their income from farming and are typical of the farmers who produce the majority of this nation's farm crops.

In looking at the issue from a broader viewpoint, we find that U. S. Department of Agriculture data indicates that farmers invested $9.7 billion in property which qualified for the investment credit during 1983. Based upon the University of Illinois farm operator's data and our example, we believe that the repeal of the investment credit would increase the Federal income taxes of the U. S. farmer by approximately $970 million per year while the increase in personal exemptions and the lower tax rates would decrease his taxes by $380 million. The net result is an increase in the farmers' tax burden by an estimated $590 million per year.

The adverse impact of the President's tax program creates a substantial additional cost burden for farmers who are still enduring one of the longest farm recessions in history. Pending farm legislation promises to result in a substantial reduction of federal assistance for agriculture under farm commodity programs. If executed with a prudent degree of gradualism, we support such reductions and a farm policy which over time leads to our agriculture operating on more of a "free market" basis in order to regain competitiveness in world commodity markets. However, in order to compete effectively in world markets, our farmers need to have state-of-the-art farm machinery and other capital inputs which can help them become lower cost producers.

Farm commodities represent a substantial portion of this country's exports. Considering the increasing trade deficit, we cannot afford to increase the costs or reduce the efficiency of our nation's farmers. Tax legislation which adds another financial impediment to the ability of our farmers to cope with current adverse economic circumstances while they simultaneously attack worldwide competitive challenges would be most unfortunate and, we believe, ill-advised. The repeal of the investment credit causes the President's tax proposal to add to the current and future economic burden and challenges of U. S. agriculture. It is indeed ironic that a tax bill which promises to provide reductions in taxes for almost 80% of all individual taxpayers, substantially increases the tax liability of our nation's farmers who can least afford it.

As stated earlier, Mr. Chairman, the repeal of the investment tax credit would have a negative impact on farm equipment manufacturers by increasing their cost of capital goods while also reducing the demand for farm equipment. But more importantly, it will increase the cost of farmers' capital goods and the cost of producing farm commodities. The continuing weakness of the farm economy and the competitive challenges from overseas facing our farmers causes the impact of the repeal of the investment credit to be felt more keenly than would normally be the case. We therefore request that this committee not penalize the farmer by raising his individual income tax but instead continue the investment credit at least as it relates to farm operators.

I appreciate your time and attention and wish you success in your difficult deliberations. I would be glad to respond to any questions you may have for me.

Exhibit A

Impact of Investment Credit Repeal on a Typical Illinois Farm Operator

		Current Law	Proposed Law
1.	Net Farm Income	$13,916	$13,916
2.	Non-Farm Income	6,660	6,660
3.	Total Income	20,576	20,576
4.	Add: Depreciation Decrease Due to Reduction in Basis of 1/2 of Investment Credit	111	-
5.	Balance	20,687	20,576
6.	Less: 4 Exemptions	(4,000)	(8,000)
7.	Taxable Income	16,687	12,576
8.	Tax Before Credits	1,863	1,286
9.	Less: Investment Credit (10% of $14,790)	(1,479)	-
10.	Tax Due	384	1,286
11.	Increase in Tax Under Proposed Law	902	

Analysis

The tax is decreased by $577 by the increased zero bracket amount, increased deduction for exemptions and lower tax rate. However, the loss of the investment credit of $1,479 results in an increased tax of $902. This typical Illinois farmer will see his Federal income tax more than triple from $384 to $1,286.

The CHAIRMAN. Mr. Coulter, you are a practicing cattleman. Right?

Mr. COULTER. Yes, sir.

The CHAIRMAN. No other significant source of outside income?

Mr. COULTER. I do farm as well, Senator. I raise some dry land wheat out there, but basically, agriculture.

The CHAIRMAN. You think, and the National Cattlemen's Association thinks, that it would be adverse to your interests—family farm, cattle interests—to repeal capital gains for the breeding livestock and dairy cattle?

Mr. COULTER. Yes, sir.

The CHAIRMAN. And Mr. Hassebrook thinks the opposite, although both I think honestly are trying to speak for the same groups—small, individually operated farms. I am curious if you would each comment again why you have come to opposite conclusions when you are both supporting basically the same person? I will start with you—why you think it would be adverse to lose it, and then Mr. Hassebrook why you think it would help.

Mr. COULTER. One of the reasons, Senator, that I would feel that would be adverse is, first of all, I am specifically talking about the livestock industry and the cattle portion of that. The association that I am representing is specific a cattlemen's association. Second, we have a resolution on our books which has been there for some time, and which seems to stand year after year. I served as chairman of that resolutions committee for some 5 years. There is usually an assault upon that and some other things in the tax committee. That resolution has prevailed. So, it is the studied opinion of our association—those people who participate—that this is something that is valuable to us and should be retained.

The CHAIRMAN. Why is it valuable? Why isn't it harmful? Let's just limit ourselves to cattle. Then, you can answer on that, and Mr. Hassebrook, you can respond to cattle, but why is it helpful?

Mr. COULTER. It is helpful because it reduces the Federal income tax implications when you sell a breeding cow. This cow is not held primarily for sale. She is put into the herd either by purchase or by raising that cow. She is utilized in that operation as part of the factory. She produces a calf every year—or under present economic conditions—she produces one every year or she goes to town, and at the end of her useful life, she is sold in a salvage-type sale, generally speaking. She is a capital asset, and she should be afforded capital asset treatment upon disposal. The cattle that are held in that herd primarily for sale should not be accorded that, but the breeding herd is part of the factory. She is similiar to a machine tool. She is put into service in that business to produce a salable product; and at the end of her useful life, she is sold. Quite often, that salvage value is less than had she been sold as a 2-year-old as a breeding animal.

The CHAIRMAN. Mr. Hassebrook.

Mr. HASSEBROOK. There is no question but that the capital gains exception has helped a lot of individual farmers reduce their tax burdens. The problem is that, when you take a long-term look at it, you see that these provisions are leading to our collective demise. You know, when we look at what kind of a system of agriculture we want to have and the long-term profitability, I think the closer we look at it, the less sense I see it making. First of all, when we try to help farmers by giving them a tax break, it is a very inequitable form of help because the people who get the most help are those that need it least—in the highest brackets. And so, the well-established farmer who is expanding is given a competitive advantage over the young person trying to get started with limited capital, and the well-established farmer is put at a competitive disadvantage to the high-bracket investor or corporation who is trying to invest in the industry for a tax shelter. And in the long run, I have to say that there is a restructuring in farming toward a much greater concentration of wealth, toward separation between the people who own farms and farm assets and the people who work them. And if we really believe in maintaining opportunity for people in agriculture, it is just very counterproductive to that. And additionally, I think we just have to ask in agriculture—an industry that is consistently burdened with overproduction and low profitability—whether it makes any sense to make farm assests tax shelter items because when you do that you are going to get more of them. And you are going to get less profit from farming itself.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Mr. Chairman, I would like to follow up on that same question. I don't understand yet why you would favor repealing capital gains treatment for breeding stock. I understand Mr. Coulter's position, I think. Your response was more general. It wasn't specifically aimed at capital gains treatment of breeding stock. Why do you favor repealing capital gains treatment for breeding stock?

Mr. HASSEBROOK. Specifically, it creates a very strong incentive to expand the breeding herd, and it gives a better advantage to the high bracket investor or the larger farmer over the beginning farmer or the small farmer.

Senator BAUCUS. Is there a difference between hogs and cattle?

Mr. HASSEBROOK. There may be in degree, but the effect is the same. I mentioned the tax shelters and the so-called one-litter gilts in the hog industry, and you have tax shelter investments in cattle breeding as well.

Senator BAUCUS. It is your view that this capital gains treatment for breeding cattle tends to create an improper incentive for the producers to do what? To raise a lot of breeding stock themselves? To turn over breeding stock?

Mr. HASSEBROOK. It encourages a higher turnover and it encourages an expansion of the whole herd. Both of those are encouraged by it.

Senator BAUCUS. What is your response, Mr. Coulter, to that?

Mr. COULTER. First of all, Senator, I would say that there is a difference between the hog situation and the cattle situation. I think they can be distinguished, and again, I don't want to get into that because I am not a hogman. I am speaking for the cattle people. There are some abuses. There have always been some abuses in the capital gains treatment of breeding cattle or probably any other asset that can be capital gained. I am sure that there are people out there who look upon that as an opportunity to shelter some tax dollars. That doesn't mean we need to throw the whole system out to take care of a limited number of abuses. I do believe that in the breeding herd situation in cattle there are a very limited number of abuses. Most of those have taken care of themselves. The economics of the business have——

Senator BAUCUS. Let me turn to the question of limiting outside investment.

Mr. COULTER. Yes, sir.

Senator BAUCUS. That seems to be a question these days, and I think it is a difficult one to resolve. I can see the argument that unlimited, outside investment tends to encourage overproduction, to change the character of agriculture, and certainly to change the character of family farming in America. On the other hand, a lot of people in agriculture seek outside investment to stay alive. They are afraid they are going to lose their outfit if they don't have outside income. Beyond that, if you limit outside investment or limit the degree to which nonfarm income can be set off against farm losses, you raise the question of accounting complexity. And then you may set a precedent for other area. So, I'd like all of you—in the limited time that we have—to very succintly to give me your views on the degree to which we should limit the amount of nonfarm income that could be set off against farm losses.

Mr. COULTER. Where would you like to start?

Senator BAUCUS. I will start with you, Mr. Coulter.

Mr. COULTER. OK. I think that probably we need to point out we do have a different philosophy here—basic philosophy. But basically, I think that agriculture is capital intensive. It has become much more so in recent years, and perhaps not all of that equity can be provided internally. We therefore go outside in all sorts of schemes to bring money in. Some of that may be investor capital.

Senator BAUCUS. Do you favor any limitation?

Mr. COULTER. I'm sorry I didn't hear you.

Senator BAUCUS. Do you favor any limitation on any outside equity or outside financing?

Mr. COULTER. I don't think so. I think the marketplace will pretty well take care of that. It could be addressed in other parts of the code. We do not have a resolution asking for more restrictions. If you lower the income tax brackets, you remove some of that incentive.

Senator BAUCUS. Mr. Hassebrook.

Mr. HASSEBROOK. I think the last thing we need in agriculture right now is more capital. We are overcapitalized, and so I don't think we need more outside investment. I would say of the limitations: As far as whether or not outside investment is the way to help individual family farmers, if the public or the Government has the money to subsidize that through the Tax Code in a very inequitable way which encourages absentee ownership—I suggest the public just subsidize it directly, through a loan program or whatever, if that is needed. At the very least, I would say, if it is going to be outside——

Senator BAUCUS. Would you propose that a program designed to give either grants or loans to farmers, in addition to the farm programs that we have?

Mr. HASSEBROOK. I think the Farmers Home Administration may need to be beefed up, particularly for beginning farmers, but I mean I think there is a limited role for that, but there is a role for it. But not for everyone, no.

Senator BAUCUS. Do any of the others on the panel have any views on this question?

Mr. RAHJES. Mr. Chairman, I would certainly reiterate what I indicated in my testimony that the best cure for tax shelter activities would be lower marginal tax rates. Also, I would indicate that outside sources, or outside people who would use tax shelters, they should be in some way limited as to unrelated income. Now, what the figure is, I am sorry I don't have a figure for you at this time, but I would say that if the income is totally unrelated, there probably should be some way to limit that.

Senator BAUCUS. To limit what—the investment or the offset?

Mr. RAHJES. The offset.

Senator BAUCUS. You heard the proposal that Senator Abdnor made. I think it is roughly $23,000.

Mr. RAHJES. I think he said $24,600. I don't know where he came up with the $600.

Senator BAUCUS. Is that in the ballpark?

Mr. RAHJES. Something like that probably would be—again I don't want to pinpoint a figure, but something like that would certainly be in the ballpark.

Senator BAUCUS. Anyone else?

Mr. HANSON. We think there may have been some abuses, and we recognize the accounting problems that it creates. On the other hand, we think legislation can be promulgated that would solve a lot of that—something along the lines that the American Farm Bureau has suggested. We would be very happy to work with the staff on that.

Senator BAUCUS. What about limitation?

Mr. HANSON. Yes; we think some limitation on a percentage basis would be applicable in this case. Yes.

Senator BAUCUS. All right. Thank you very much.

The CHAIRMAN. Senator Long.

Senator LONG. I just wanted to address this question. I am somewhat familiar with a situation of a couple that went into business producing livestock. They worked awfully hard for the last 15 years, borrowed money, bought some land, bought some livestock, and have tried to continue to improve their product as well as their land. And as they have tried to expand, they could find money to do so. Their problem is that the livestock is down. That is hurting. And two, the value of land is down, and they owe a lot of money on that land. Now, that land is not down as much as the average for the whole United States among farmers. They are concerned about this tax proposal. If we do what is suggested here, let's just say we are going to drive these people out of this business who came in to make some money and who are not really farmers at heart. Their thought is that that is going to cause a lot of those people to move out of that business, and when they sell out for whatever they can get—just sell out and get out, which apparently I think would happen if we follow some of these suggestions—that is going to make the value of the product go down a lot more. It is also going to make the value of the land go down a lot more. As far as this couple is concerned, as it stands right now they still have a very substantial equity after 15 years of hard work. It looks to me that with the declining value of their land and the decline in value of their livestock, between the two they could be wiped out. Do you see that as a possibility, Mr. Coulter?

Mr. COULTER. Yes, sir; unfortunately, we don't have to change the Tax Code to do that. The economics of today, the high interest rates, and the fact that we have very few viable buyers out there has already done that.

Senator LONG. But if you change the law so that you have a lot less buyers and a lot more sellers, doesn't that accelerate that process?

Mr. COULTER. That is surely going to accelerate that. Now, again, I would hope that that would be a shortrun effect, that we would see some profitability someday, and there would be buyers out there who could buy that land on a cash-flow basis, but you have exactly described the situation in Nebraska and Iowa today because our land values have declined a great deal more; and with the high interest rates that we are getting from farm credit and other lenders, it doesn't make sense to go borrow money to buy land today. Perhaps those interest rates—if they were down to where they ought to be—and again, if that land were at a lower price from a buyer's standpoint, it would be more attractive. But the fellow who has been out there 15 or 20 years and put his life's work into it may not have anything left to show for it. You are absolutely correct, sir.

Senator LONG. Mr. Rahjes, what is your thought about this situation?

Mr. RAHJES. Certainly, there are very significant problems out there today. And with the incentive, or the disincentive there is to stay at the present time, that causes us a lot of worry. As we confront the question of driving other people out, I think it boils down to a very critical line, and that is: Is that person involved in agriculture strictly for tax shelters? Strictly, and he cares not for agriculture for any other reason at all. Now, I think there are probably some of those out there, and we would like to indicate that they need to have some restraint, but those people who are actually out there working and trying their best to work through the situation that we are in, should have every possible chance that they could have and should not have any further restraints that what they have now.

Senator LONG. I take it that you are not in favor of something then that would have the effect of increasing their taxes?

Mr. RAHJES. Oh, no. No increase in taxes. Definitely not.

Senator LONG. Now, Hassebrook, your view seems to be that you would like to run out of this those persons who are not dirt farmers or not the ones who have stayed on the farm and lived there and worked with it. Is that correct?

Mr. HASSEBROOK. Yes; if I might respond to the issue you raised about land prices, I would have to say that I think a tax shelter investment really laid the groundwork for the problem that we are having today in the land market. I mean, there is no question but that farmland prices were inflated far beyond the potential of farmland, you know, in the late 1970's. It got to the point where the only people who could afford to buy land were those who could afford to speculate, and many who thought they could found out they couldn't. It was those high land values and overvalued land that has gotten many people in trouble today. I think you will find that right now the tax shelter investors are already gone, simply because what they came in the land market for was tax favored capital gains. And the capital gain has been long gone from the farmland market. I saw a quote the other day in the Successful Farming magazine from the guy who runs the largest farm management company in the country, and he said that in areas where there is a lot of land held by nonfarm investors, the land prices are weakest; whereas if you go into the areas where the land is owned by owner operators, that is where the land price and the land market remains strong today.

Senator LONG. Where do you come down on that, Mr. Hanson?

Mr. HANSON. The couple you described spending 15 years on the land in the cattle farming business—unless the man is a doctor on the side and his wife is a lawyer, we classify that group—that couple—as a legitimate farming operator, and we think they need the kind of tax considerations that we are talking about—the investment tax credit and other considerations.

Senator LONG. Mr. Hardiek, where do you come down on it?

Mr. HARDIEK. I certainly agree with Mr. Hanson.

Senator LONG. All right. Thank you very much.

The CHAIRMAN. I have no further questions, Senator Long. If you want to go on, we have a vote pretty quick.

Senator LONG. No; thank you.

The CHAIRMAN. Senator Exon.

Senator EXON. Mr. Chairman, thank you very much, and I appreciate your allowing me to come in and partake in this very interesting hearing. Let me explain for a moment, if I can, to the committee—which I think there is some confusion—how can we have two people from Nebraska testifying here, seemingly at opposite ends of the pole? Let me see if I can explain that, and if I don't explain it properly, I invite my two constituents from Nebraska to correct me. Basically, I think what we tend to do here is to consider farmers are farmers are farmers. And farmers are not farmers are not farmers are not farmers. There are cattle farmers, and there are hog farmers, and there are cattle farmers. I would suggest that probably the best way to understand this is that probably I would say that Mr. Hassebrook represents what we may picture in our history as the typical family farm operation, where, you look at the books and you see the chickens in the back yard and the geese running around and a few cows that they milk, some grain. Where I think it would be fair to assume that Mr. Coulter represents the livestock producer, particularly the large cattle producer, and they have such different problems that they are dealing with today. Sometimes we here in Washington fail to recognize in real life that there is a connection between what the farm bill provides, on one hand, and what the tax incentive or lack thereof provide on the other. I find myself somewhere probably in between the views expressed by my two Nebraska constituents here today. I would certainly have to say, though, that I really believe that this tax shelter investment and outside equity by and large have not been in the interest of the family sized farmer. Whether that is in the cattle industry or whether that is in the grain production industry, let me say it another way. I suspect that it would be fair to say that Mr. Hassebrook represents the grain farmers more than does Mr. Coulter. They have both got critical problems out there today. They are both in serious, serious trouble, so I don't want to have the committee confused that these two people are coming at us from different points of view. They are probably best representing the people that they represent here. About the only thing that you could get the two of them to agree on specifically, I would suggest, would be that Nebraska has the greatest college football team in America today. Other than that, it is typical; and the difficulty we have getting farm legislation through and coming up with fair tax policy is the fact that they come from different parts of the farming industry. And a farmer, to people here, is not necessarily what the realities are out there meeting the food production needs of America. Having said that, I suggest, Mr. Chairman, that probably the threshold of $24,000 suggested by one of the witnesses may be too low. As I guess has been said here, it may be somewhere along that line. You have to have something if we are going to protect what most of us feel are the family sized farmers. So, I simply wanted to try and straighten that out, and I thank my two friends from Nebraska and the other witnesses that I thought were very informative this morning. I don't think you have confused the committee as much as some might like to think because so many of the questions today were to try and get specifics in the record that would help us write proper legislation here as far as taxes are concerned. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you. Gentlemen, we are adjourned.

[Whereupon, at 12:41 p.m., the hearing was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

STATEMENT OF SENATOR JOHN C. STENNIS
BEFORE THE SENATE FINANCE COMMITTEE
JULY 10, 1985

MR. CHAIRMAN, I AM DELIGHTED THAT YOU ARE HOLDING THESE HEARINGS ON THOSE PORTIONS OF THE PRESIDENT'S TAX REFORM PACKAGE WHICH AFFECT TIMBER. THIS IS A VERY IMPORTANT MATTER AND IT DESERVES THE CAREFUL ATTENTION OF THIS COMMITTEE.

AS YOU KNOW, FOR MANY YEARS I HAVE TAKEN A SPECIAL INTEREST IN THE TIMBER AND FOREST PRODUCT NEEDS OF OUR COUNTRY. I HAVE STUDIED THE TIMBER INDUSTRY CAREFULLY. ALTHOUGH I WOULD NOT CALL MYSELF AN EXPERT, I DO HAVE FIRST-HAND KNOWLEDGE ABOUT THE GROWING OF TIMBER IN MY OWN AREA. I HAVE WATCHED WITH SATISFACTION AS THE QUALITY AND EXTENT OF TIMBER PRODUCTION HAS EXPANDED IN MY STATE.

IN MISSISSIPPI, TIMBER IS NOW THE THIRD MOST IMPORTANT AGRICULTURAL PRODUCT. LAST YEAR TIMBER PRODUCTION IN THE STATE AMOUNTED TO $518 MILLION, AND IT HAS AVERAGED HALF A BILLION DOLLARS PER YEAR FOR THE LAST FIVE YEARS.

ROUGHLY 55% OF THE ACREAGE OF MISSISSIPPI IS IN TIMBER LAND. MOST OF THIS IS PRIVATELY OWNED BY INDIVIDUAL LANDOWNERS. THE LARGE TIMBER COMPANIES OWN ONLY 18% OF THE STATE'S TIMBER ACREAGE. MUCH OF THE TIMBER IN THE STATE IS IN SMALL HOLDINGS. OVER HALF OF THE GENERAL PRIVATE OWNERSHIP OF TIMBER LAND IN THE STATE CONSISTS OF TRACTS OF 50 ACRES OR LESS.

AS YOU CAN SEE, MR. CHAIRMAN, I AM TALKING ABOUT AN IMPORTANT PART OF MY STATE'S ECONOMY, BUT I AM ALSO SPEAKING FOR MANY THOUSANDS OF SMALL LANDOWNERS. THESE ARE THE PEOPLE WHO PROVIDE THE BULK OF CUT TIMBER IN MY STATE, AND THEY ARE THE PEOPLE WHO WILL BE HURT MOST BY THE PRESIDENT'S TAX PROPOSALS.

ONE OF THE THINGS THAT I HAVE LEARNED FROM WATCHING THE GROWTH AND PRODUCTION OF TIMBER IS THAT IT TAKES A LONG TIME--AT LEAST THIRTY YEARS--FOR GOOD TIMBER TO GROW TO MATURITY. THATS A LONG TIME FOR A PERSON TO WAIT FOR A RETURN ON HIS INVESTMENT. THAT'S A LONG PERIOD OF MANAGEMENT, PROTECTING THE TIMBER AGAINST THE THREATS OF INSECTS, FIRE, AND OTHER NATURAL HAZARDS. THAT'S A LONG TIME BEFORE ONE CAN ENJOY THE SATISFACTION OF SEEING A STAND OF TALL TIMBER HARVESTED.

BECAUSE OF THE LENGTH OF TIME FOR TIMBER TO GROW AND BECAUSE OF THE MANY UNCERTAINTIES THAT MAY OCCUR DURING THAT PERIOD, WE HAVE RECOGNIZED THE NECESSITY OF ENCOURAGING PEOPLE TO MAKE LONG-TERM INVESTMENTS IN TIMBER. IN MY OWN STATE, FOR EXAMPLE, BACK IN THE 1940S THE STATE LEGISLATURE EXEMPTED TIMBER LAND FROM THE AD VALOREM TAX. INSTEAD, TIMBER IS TAXED ONLY WHEN IT IS CUT THROUGH A SEVERANCE TAX.

AT THE FEDERAL LEVEL WE HAVE ALSO UNDERSTOOD THE IMPORTANCE OF ENCOURAGING TIMBER PRODUCTION. WE HAVE GIVEN TIMBER SPECIAL CAPITAL GAINS TREATMENT AND WE HAVE ALLOWED TIMBER MANAGEMENT COSTS TO BE DEDUCTED IN THE YEAR THAT THEY ARE INCURRED. A FEW YEARS AGO I HAD THE PRIVILEGE OF SPONSORING THE FIRST MAJOR INCENTIVE PLAN ADOPTED BY CONGRESS, FOR ENCOURAGING THE GROWING OF TIMBER BY SMALL LAND-OWNERS. AND I WAS PLEASED THAT A FEW YEARS AGO, UNDER YOUR ABLE LEADERSHIP, WE PROVIDED ADDITIONAL INCENTIVES FOR REFORESTATION OF TIMBER. THE RESULT OF THESE

ACTIONS HAS BEEN THE CREATION OF A STRONG TIMBER INDUSTRY, WITH NEW ACRES BEING ADDED TO PRODUCTION AND BETTER MANAGEMENT LEADING TO GREATER YIELDS FROM OUR TIMBER RESOURCES.

MR. CHAIRMAN, MY FEAR IS THAT THE ADMINISTRATION'S TAX REFORM PROPOSAL WOULD ADVERSELY AFFECT OUR TIMBER INDUSTRY IN TWO MAJOR WAYS. FIRST, IT WOULD SIGNIFICANTLY INCREASE THE COST OF TIMBER, THEREBY HURTING THE ABILITY OF OUR TIMBER INDUSTRY TO COMPETE IN BOTH DOMESTIC AND WORLD MARKETS. AS YOU WELL KNOW, THE INDUSTRY IS ALREADY SUFFERING FROM CANADIAN IMPORTS. CANADIAN SOFTWOOD LUMBER IMPORTS NOW CAPTURE 31.6% OF THE TOTAL U.S. SOFTWOOD CONSUMPTION. IN MISSISSIPPI, CANADIAN LUMBER HAS OVER 12% OF THE MARKET. WOODYARDS ARE CLOSING ALL ACROSS THE STATE. COUNTIES THAT HAD SEVERAL WOODYARDS AS RECENTLY AS THREE YEARS AGO NOW HAVE NO WOODYARDS AT ALL OPERATING.

THE SECOND WAY IN WHICH THE PRESIDENT'S PROPOSAL WOULD BE HARMFUL IS IN ITS EFFECT ON OUR ABILITY TO MEET NATIONAL TIMBER NEEDS, FORCING US TO RELY EVEN MORE HEAVILY ON IMPORTS. BOTH REDUCE INVESTMENT IN TIMBER AND REDUCE THE LIKELIHOOD OF GOOD TIMBER MANAGEMENT. THIS WILL INEVITABLY REDUCE THE SUPPLY OF TIMBER. THE UNITED STATES FOREST SERVICE ESTIMATES THAT THE DEMAND FOR PAPER AND WOOD PRODUCTS IN THIS COUNTRY MAY DOUBLE BY THE YEAR 2030. ALREADY THE FOREST SERVICE IS PROJECTING A SHORTFALL IN THE ABILITY OF TIMBER PRODUCTION TO MEET OUR ANTICIPATED NEEDS OVER THE NEXT FORTY TO FIFTY YEARS. THIS PROBLEM WILL ONLY INCREASE IF THE PRESIDENT'S PROPOSALS ARE ADOPTED.

IN MISSISSIPPI WE NEED TO REFOREST 12,000 TO 13,000 ACRES PER YEAR TO MAINTAIN OUR CURRENT PRODUCTION LEVELS. BY 1990, THIS WILL REACH 17,000 TO 18,000 ACRES PER YEAR. NATIONWIDE WE NEED ROUGHLY 400,000 ACRES OF REFORESTATION PER YEAR. BY 2030 THE NEED WILL BE 600,000. I AM AFRAID THAT WE WILL SIMPLY BE UNABLE TO MEET THESE NEEDS IF CURRENT TAX INCENTIVES FOR TIMBER ARE ELIMINATED.

MR. CHAIRMAN, I AM PARTICULARLY CONCERNED BY THE FACT THAT THE PRESIDENT'S TAX PACKAGE APPEARS TO SINGLE OUT TIMBER FOR PARTICULARLY HARSH TREATMENT. AS FAR AS I HAVE BEEN ABLE TO DISCOVER, NO OTHER MAJOR INVESTMENT ACTIVITY RECEIVES TREATMENT THIS SEVERE. AND YET NO OTHER INVESTMENT THAT I KNOW OF TAKES AS LONG AND REQUIRES AS MUCH ON-GOING CARE AS TIMBER. QUITE FRANKLY, I JUST DO NOT THINK THIS IS FAIR.

MR. CHAIRMAN, WE HAVE WORKED FOR YEARS TO ESTABLISH A STRONG TIMBER INDUSTRY. WE NOW HAVE THOUSANDS OF ACRES OF CAREFULLY MANAGED SOUTHERN PINE ALL ACROSS THE SOUTH. WE HAVE SEEN THE LARGE BENEFITS THAT COME FROM A FEW TAX INCENTIVES. BUT WE NOW FACE THE POSSIBILITY OF A SHORTFALL IN MEETING OUR PROJECTED TIMBER NEEDS. THIS IS SIMPLY THE WRONG TIME TO REMOVE THOSE INCENTIVES THAT HAVE CREATED A STRONG AND HEALTHY TIMBER ECONOMY. I HOPE THE COMMITTEE WILL MAKE MAJOR CHANGES IN THIS PORTION OF THE PRESIDENT'S TAX PLAN.

American Association of Nurserymen, Inc.
1250 I Street N W Suite 500, Washington, D C 20005 (202) 789 2900

Statement For The Record
Of
John J. Satagaj
For the Hearing on the Impact of Tax Reform on Agriculture
Before
The Committee on Finance
U.S. Senate
July 10, 1985

On behalf of the American Association of Nurserymen (AAN) I would like to submit the following comments on the subject of tax reform.

AAN represents over 3,300 firms involved in the nursery industry. These firms include wholesale growers, landscape companies, garden centers and mailorder nurseries. The overwhelming majority are small businesses.

Our industry is dominated by stable, mature firms, privately owned and operated. In many cases several generations of a family have participated in the operation of the business. By nature, our businessess demand hands-on, active management in order to be success and as such, do not lend themselves easily to tax shelter activity.

Let me say, first, that we support the efforts of the President and this Committee to enact tax reform. We were particularly impressed by the President's comments on small business upon the introduction of his proposal. There are several general themes we support which I will not discuss here. We endorse the comments of the Small Business Legislative Council, of which AAN is a member.

I wish to address a single matter of critical concern to our industry, which also highlights the inherent difficulties in instituting sweeping revisions of our tax system.

As this Committee knows, not all provisions of the code were placed there to serve as an incentive to induce a certain economic or social activity. A substantial portion of the code reflects business practices and realities. While perhaps "flawed" from a textbook tax economics viewpoint, these provisions provide the flexibility to allow firms to conduct business in a manageable way.

In our case, the code "bends" to reflect the problems we have in accurately inventorying growing crops. If I can, I'll try to explain how and why we have arrived at the current tax treatment of our growing crops.

The nursery industry is a $5-billion-plus industry with grower production on the order of $1.75 billion, yet the nature and management of our business is frequently a mystery to the business economy around us, the financial community and, most especially, the Internal Revenue Service.

In most respects, a nursery grower is a farmer, with ties to the soil, the seasons and the vagaries of nature. For as long as anyone in this industry can remember, and certainly long before, the government has dealt with the nursery industry as part and parcel of the agricultural community. This has made eminent sense, and we have always supported this position. Wage and hour, environmental, transportation and tax regulations all recognize the differences between farming and manufacturing and have provided for different systems of regulation. The tax code, in particular, has fine tuned governmental necessity to match the realities of the farmer's business.

In one important regard, the nursery industry represents a unique subset of agriculture; our principal product is the result of a complex, individualized production system that defies neat categorization for tax purposes.

The central problem is the unique growing period of our product. Unlike the typical farmer, plants are not harvested in the same year they are grown, nor are all plants, planted at the same time, harvested at the same time. Further, most nurseries are growing many varieties of plants which require individual attention.

Nursery stock is generally planted in rows like other agricultural crops and is cultivated by the same type of farm labor and equipment (plows, discs, cultivators, etc.).

Production of nursery stock is not as simple as sowing and harvesting a crop of wheat or corn, however. For example, some types of evergreens are first propagated from cuttings in a greenhouse. After several months in the greenhouse, the rooted cuttings (a portion of which might be sold to other nurseries) are kept in plant beds, usually for two years. These three year old cuttings (a portion of which might be sold to other nurseries at this time) are planted in fields and cultivated for four or five additional years until the trees become of marketable size for the consumer.

Some evergreens may be propagated from seeds. These seeds are planted in the autumn, out of doors, and remain in the seed bed the entire following year. Then the plants are potted, and sold to other nurserymen as "understock" for grafting, or the nurseryman may pot his seedlings and place them in his own greenhouse for grafting. The stock thus produced will subsequently be planted and cultivated in fields as previously described.

Thus, a nurseryman with marketable evergreens might have produced them either from his own seed, from his own cuttings, or from seedlings or cuttings purchased from another nursery. In any event, the nurseryman will himself have transplanted the plants one or two times, and will have cultivated them for several years. It would be virtually impossible for him to follow each of the hundreds or thousands of plants to determine how many perished in each transplanting or during the years of cultivation.

Furthermore, he would be extremely fortunate if he were able to sell all of the trees that he has grown.

Bare root production requires the grower to dig a whole row, yet some trees are too big or too small for market demand. Some of these are "graded out" for improper root structure or branching structure, and must be destroyed. Loss at this point can range anywhere from 10% to 30%.

If not sold at a favorable age, (unlike a can of beans or a beef steer), the unharvested trees will have to be destroyed. Nursery stock standing in fields, or spoiling in storage, is a liability and is not comparable to bins of wheat, herds of cattle, or shelves of non-perishable merchandise. Keeping an inventory of growing stock is not as simple as tracking these items.

Another example, could be roses. A nurseryman may purchase thousands of rose cuttings and plant them in the fields, where they are grown for one year solely to develop a satisfactory root system and a stem suitable for budding. Buds from the desired variety (either purchased or available from his own stock) are then budded to the understock. The result will be a rose bush with a strong root system, with tops of the desired species. An undetermined number of the cuttings will have perished since they were originally planted, due to the "vicissitudes of nature", including weather and pests. And, of course, not all of the buds will successfully unite with the root stock.

The rose bushes successfully produced must be sold by the autumn of the second year, or the following spring, or be destroyed. It can be seen that determination of the "cost" of a rose bush at some given time during the production cycle is virtually impossible.

Other varieties of trees, shrubs and plants have varying methods of production but are no more susceptible to cost determination than roses or evergreens. In addition to all the factors, insect, disease and weather take their toll on individual plants.

The last two winters have dramatically demonstrated the havoc which can be created by unpredictable weather. Plants with an eventual value of millions of dollars have been destroyed by the freeze. A freeze does not hit a nursery uniformly; plants of various sizes, in different locations, are affected in a somewhat random fashion.

It must be kept in mind that seldom does a nurseryman sell an entire "crop" in any given year. For example, a given block of evergreens containing trees planted in the field at the same time will not contain trees of the same size, due to differences in individual rates of growth. Thus an order for evergreens of a given size (e.g. an 18-inch spread), may be filled out of several fields of trees of different ages.

Individual orders for trees of widely varying ages, sizes and species are also often received. Suffice it to say that seldom, if ever, are all the trees of any given block sold in the same year.

Some trees could be held for ten more years!

To maintain cost figures for each tree in each block would be impossible, particularly in view of the small office force, if any, which a nurseryman can afford.

The problem from a tax standpoint becomes how does one treat expenditures incurred during this process, how does one value the crops, conduct an inventory or report income?

In the case of most manufactured items, such as bolts or radios or books, the manufacturing cycle is relatively short and a homogenous, durable product is produced. As a result, it is relatively simple to inventory labor, materials, and overhead costs and to relate costs to products as they are sold.

It is virtually impossible to trace the costs of producing specific plants through the lengthy production cycle. The nurseryman would first have to determine which costs should be inventoried.

Theoretically, the nurseryman could be required to inventory the cost of seeds, young plants, preparatory and periodic cultivation, weeding, insecticides, labor, and numerous additional cost elements.

The nurseryman would then have to establish a rational means of allocating these costs to thousands of plants of widely varying type, age, size, and quality, and reallocating the costs associated with the many plants which die during each year.

Finally, the nurseryman would have the laborious task of counting and classifying all his growing stock at least once a year, possibly under such adverse field conditions as rain, snow and mud.

Most nurseries use the calendar year as their fiscal taxable year. Approximately 50% of all nurseries are located in northern states that will normally have snow cover on December 31st, making a physical count of the plants in the fields impossible to inventory.

Valuing beginning and ending inventories either at the lower of cost or market, or at the market value of the plants on hand less disposition costs (i.e. using the farm pricing method), would be equally impractical.

Under the lower of cost or market standard, the nurseryman would have to perform all the calculations described above to determine the costs reflected in his inventory and <u>then</u> determine the market values of the thousands of plants on hand. Under the farm-price method, the nurseryman would have to take a physical inventory, determine the market value of the many plants, and arbitrarily estimate the substantial cost of removing all the plants from the ground and disposing of them.

The industry, Congress and the Internal Revenue Service have developed a system which has been in place for over sixty years. This issue was explored in depth in the period between 1974 - 1973 by Congress and the IRS. In 1976, Revenue Rule 76-242 revoked the longstanding 55-year-old position of the IRS thereby requiring farmers, nurserymen and florists to inventory growing crops, trees, and plants.

Upon realizing the disasterous effect this ruling would have on a small number of businesses, the IRS extended the effective date to apply to the taxable years beginning after January 1, 1978. Both Congress and the IRS came to the same conclusion, there were in fact legitimate business reasons to exempt nurseries from crop inventories, regardless of their accounting system.

The final word on the subject by Congress can be found in the Revenue Act of 1978, Section 352 (Attachment #1) and IRS Revenue Ruling 79-102. As a practical matter, a growing nursery's plants have no value until sold. At that time, the nursery reports sales as ordinary income. Inventories, which are impossible to keep, are not required. Cash method nurseries have been exempt, as are most farmers, from inventory responsibilities under Treasury Regulation 1.471-6(a), and Section 447(a)(2) specifically exempts accrual accounting nurseries from inventories. The result is that expenses, including the cost of seedlings, are taken as ordinary and necessary expenses in the year they are incurred under Treasury Regulation 1.162-12(a). Of course, under Treasury Regulations the nursery must consistently use the same accounting practices from year to year.

A consistent application of cash basis accounting between years is exacting, simple, easy for the IRS to audit tax returns, and does not eliminate taxes or even defer taxes, therefore, there is no increase in tax revenues to be gained.

If nurserymen are required to inventory crops or convert to accrual accounting, a substantial increase in costs will be incurred in internal accounting fees, computers, outside professional fees, additional borrowing costs to pay taxes before revenue is generated during the phase-in period, overall reducing taxable net income and thus reducing tax revenues. Moreover, good faith compliance efforts would often be defective due to the taxpayer's inability to obtain competent assistance or to estimate, assume and allocate costs accurately due to the complexities involved, to growing plants on hand. IRS audits of nurserymen's tax returns would be complicated substantially requiring the service to allocate additional resources without added tax revenue.

The system has worked for these many years. Alternatives such as capitalization of costs and inventories, while providing a tax "textbook" match of expenditures and income are unworkable in the real world of the nursery business.

This brings us to the President's tax proposal. In Chapter 8.01, the proposal calls for the capitalization of the preproduction costs of plants with a maturation cycle of two years or longer. Frankly, we are not certain of the scope of this provision, and the proposal does not allude to the full scope. Certainly, it appears to extend the current capitalization treatment to all types of business organizations, but that is a different issue. Our question is whether the proposal extends beyond that area to encompass all nursery crops. As I suggested, the proposal nearly requires a business impossibility.

The matter is further complicated by the proposal's recommendation to eliminate cash accounting for farmers with gross receipts in excess of $5 million. Many of our growers use cash accounting, but their reason for using it has nothing to do with size, rather it's based on the business circumstances which I have presented to you. A $5 million cap is an arbitrary figure which suggests a selection of accounting systems is based solely on size. A nursery with $6,000,000 in gross receipts, if required to incur the costs of additional accounting personnel, computers, professional CPA and tax personnel, and additional borrowing costs to pay triple taxes during a phase-in period, cannot compete and stay in business compared with a nursery with $4,000,000 in gross receipts who may have more net taxable income in the first place.

Tax regulation should not create disasterous discrimination in the ability to compete between nurserymen. The management of a nursery on an accrual system is a difficult task. How will Chapters 8.01 and 8.03 affect us? How would the Code handle situations where nurseries with $5,000,000 in gross receipts one year fluctuate down to $4,000,000 the next year due to market or climate conditions? Will the preproduction capitalization and inventory requirements override our eligibility to elect cash accounting in any circumstance? Obviously it is difficult to answer such questions without specific legislative language.

The change itself in tax regulation, even coupled with a phase-in period, can have disasterous effects. Existing nurseries, if required to capitalize the costs of the plants already in the field, and to convert to accrual accounting, would not only be required to pay taxes on revenues generated using the accrual basis accounting, but would simultaneously pay taxes on the newly created inventories.

Due to the long-term growth cycle of our crops, inventories to support the business are large in relation to annual sales and taxable net income.

In effect, cash required to pay taxes would triple during the phase-in period. Available cash is the greatest concern of all small businesses as the public markets that produce cash for large corporations are not available to small businessmen. If nurserymen must pay triple taxes during a phase-in period, a cash shortage will result creating an inability to service debt, causing business failure. See Attachment #2 as an example of the effect upon the typical nursery.

To bring this full circle, what we currently have is a tax code section which was built around business circumstances. Those circumstances remain compelling, realistic justification to continue such treatment. We would be most happy to work with the Committee on this matter. We recognize that in comparison to the revenue impact of the remainder of the proposal, this is inconsequential, but it does serve to illustrate how entire industries can be affected by the most subtle of changes.

We thank you for this opportunity to present our views.

ATTACHMENT #1

LAW -- Revenue Act of 1978

Section 352 of the Act provides as follows:

(a) APPLICATION OF SECTION -- This section shall apply to a taxpayer who: (1) is a farmer, nurseryman, or florist, (2) is on an accrual method of accounting, and (3) is not required by section 447 of the Internal Revenue Code of 1954 to capitalize preproductive period expenses.

(b) TAXPAYER MAY NOT BE REQUIRED TO INVENTORY GROWING CROPS -- A taxpayer to whom this section applies may not be required to inventory growing crops for any taxable year beginning after December 31, 1977.

(c) TAXPAYER MAY ELECT TO CHANGE TO CASH METHOD -- A taxpayer to whom this section applies may, for any taxable year beginning after December 31, 1977 and before January 1, 1981, change to the cash receipts and disbursements method of accounting with respect to any trade or business in which the principal activity is growing crops.

(d) SECTION 481 OF CODE TO APPLY -- Any change in the way in which a taxpayer accounts for the costs of growing crops resulting from the application of subsection (b) or (c): (1) shall not require the consent of the Secretary of the Treasury or his delegate, and (2) shall be treated, for purposes of section 481 of the Internal Revenue Code of 1954, as a change in the method of accounting initiated by the taxpayer.

(e) GROWING CROPS -- For purposes of this section, the term "growing crops" does not include trees grown for lumber, pulp, or other nonlife purposes.

ATTACHMENT #2

Example of the effect upon the typical nursery if required to change from the cash basis of accounting to accrual, or, if required, to capitalize and inventory growing crops.

Cash Method	
Receipts	$6,000,000
Production Expenditures	2,500,000
Purchased Nursery Stock	500,000
Harvest & Ship Expenditures	1,100,000
Interest	450,000
G & A	550,000
Selling	600,000
Taxable Income	300,000
Tax @ 33%	99,000
Cash remaining for debt services	$ 201,000
Expansion of machinery & facilities, return on investment.	

Accrual Method	
Net Sales	$6,000,000
Beginning N.S. Inventory	5,000,000
Production Costs	2,500,000
Purchase N.S.	500,000
Ending N.S. Inventory	5,000,000
Cost of Nursery Stock Sold	3,000,000
Harvest and Ship Costs	1,100,000
Interest	450,000
G & A	650,000
Selling	600,000
Taxable Income	200,000
Tax @ 33%	66,000
Cash remaining for debt services, etc.	$ 134,000

Phase in over 6 year period capitalizing existing inventories - $833,333 yr
Additional Phase in Taxes at - 33% 275,000
Cash shortage resulting in inability to service debit causing business failure - $141,000

AMERICAN FORESTRY ASSOCIATION

Founded 1875 1319 Eighteenth Street NW Washington DC 20036 telephone (202) 467-5810

Statement of

R. Neil Sampson
Executive Vice President
of

THE AMERICAN FORESTRY ASSOCIATION

on

Timber Tax Reform

July 10, 1985

The American Forestry Association is the national citizen's organization for trees, forests and forestry. We have historically supported tax policies that encourage the practice of good forest management in the private sector. We feel that the current methods of providing capital gains treatment on timber harvest proceeds, allowing the costs of management to be treated as costs of business in the year incurred, and providing extra incentive for reforestation have met our criteria for such constructive tax policy.

We will oppose changes in tax policy which will, in our judgment, (1) discriminate against forestry and forest land relative to other kinds of investment opportunities; or, (2) discriminate against one kind of forest land or one type of owner as opposed to others. We will favor tax policy changes that provide incentives for investing in forestry practices that have clearly defined public benefits, so long as those rules include some performance requirements.

The President's Tax Reform Proposal: Provisions Affecting Agriculture and Their Impacts on Family Farm Profitability and Survival

> There is no chance of preserving family farming if tax rules are not changed. There's no point in even trying unless the tax matter is addressed and corrected.
> Dr. Harold Breimyer, Economist, University of Missouri

The President is not proposing comprehensive tax reform. His proposal would eliminate some tax shelters, but continue to use the tax code as a vehicle for delivering subsidies and preferences. By contrast, the plan released last year by the Treasury Department would have eliminated most tax shelters and their negative effects on agriculture.

Nonetheless, the President's proposal would substantially lower tax rates for farmers. It would eliminate the investment tax credit, breeding and dairy stock tax shelters, and deductions for clearing and leveling to bring new land into production. These changes would reduce tax burdens on poverty level farmers, reduce incentives for corporate/nonfarm investment in agriculture; slow consolidation of farming into bigger and fewer hands; and bring production more into line with demand, thereby improving profitability and strengthening family farms in the affected sectors of agriculture. However, the elimination of the investment tax credit would in most cases be partially or wholly offset by more lucrative depreciation deductions. Furthermore, a wide range of shelters which would have been eliminated by the initial Treasury plan are maintained in the President's proposal. The combination of substantial tax rate reductions and the continuation of most tax shelters, will create a large reduction in taxes for the very wealthy. They will keep more income after taxes to accumulate more of the nation's land and other farm assets, at the expense of moderate income taxpayers who receive less of a break. Those tax reductions will add to the federal deficit, which weakens the farm economy.

Why Family Farm Agriculture Requires Tax Reform

> If a sector of the economy presents a tax shelter opportunity, it will likely have lower product prices; become owned by high-bracket taxpayers; likely have a greater separation of management from ownership; perhaps become less sensitive to market forces; and be dependent upon highly sophisticated financial and tax advisors. . . . Were agriculture less (tax) favored . . . . farmers might even be younger on the average.
>
> <u>The Effects Of Tax Policy On American Agriculture</u>, USDA

The tax code is riddled with shelters; credits and deductions which allow taxpayers to understate income or overstate losses to create tax savings. Although shelters are used in every industry, agriculture is especially affected because of tax savings provisions which apply only to farm taxpayers. As a result of tax shelters, tax consequences play a bigger role in investment decisions relative to markets and efficiency. Rapid expansion is encouraged as are speculation and investment in capital to replace labor, at levels which are often not efficient.

Tax shelters lower farm income. They are like magnets for investment. As tax shelters attract increased farm investment--whether by farmers, nonfarm investors or corporations--farm products rise in supply, lowering prices. Agriculture has become "overcapitalized". We have plowed rangeland, drained swamps, installed irrigation systems, built livestock, poultry and dairy systems, and expanded our breeding herds at the behest of the tax code, to produce more than we can sell at profit. The excess capital which creates problems in agriculture, is lost by capital starved industries where it is needed.

Tax shelters have contributed to the severe volatility in the farmland market. Economist Phil Raup warned in the May 1978 American Journal of Agricultural Economics that tax incentives for land speculation, such as the capital gains exemption and incentives for expansion of well established farms, including cash accounting, investment credit, and accelerated depreciation were driving the price of land far beyond its income producing potential and carrying the inflationary boom to its bursting point. Only those who could effectively exploit the tax benefits of land ownership and who could afford to speculate and subsidize purchases with other holdings or off farm income, could buy land. Those who needed land to make a living by farming it could not, particularly beginning and tennant farmers seeking their first land purchases. Higher land prices raised the cost of production and took the profit out of farming. Land price inflation offered speculative returns to those who could afford to speculate, but it created losses for farmers trying to pay for land by farming it.
Since hard times hit in the eighties, tax pressure on the land market has been inoperative. Farmers have lower incomes so they don't need tax breaks. Land has stopped appreciating so the capital gains exemption is of no value. The sensitivity of tax motivated investment to land price appreciation is illustrated by the report Analysis of the Implications of Selected Income and Estate Tax Provisions On the Structure of Agriculture, by Iowa State University Economist Michael Boehlje. Tax benefits make highly leveraged land appreciating at an eight percent real rate worth 44% more to a 50 percent bracket buyer than a buyer in the 16 percent bracket. With appreciation reduced to four percent, however, that advantage evaporates. The value of the land to the high income taxpayer falls by 37%. That is reflected in today's land market. Nonfarm speculators have pulled out of the farmland market. The tax component which worsened land price inflation in the seventies has now been removed, adding to the severity of the land price bust.

The impact of the tax code goes beyond the general level of commodity and land prices, to affect who will own and control agriculture. As the tax code subsidizes the replacement of labor with capital, it subsidizes the elimination of farmers. As farms get bigger in response to tax incentives, opportunities are eliminated for moderate sized and beginning farmers. The rules of farm competition are changed by tax shelters; to compete in a tax shelter industry one must competitively exploit the tax benefits to compensate for the lower profits. Those who realize only a small tax benefit suffer a net loss of income. Effective exploitation of the tax code requires a high bracket income and tax favored capital intensive investments. Thus, large corporate farms and high income investors are favored over most farmers. Expanding well established farmers are favored over beginning farmers and farmers struggling to survive.

Finally, tax shelters contribute to the federal deficit, which is a primary factor in the high interest rates and strong dollar which are devastating the farm economy.

Needed: A Progressive, Neutral, Revenue Raising and Shelter Free Tax System

A progressive tax with higher burdens on higher income taxpayers than those with lower incomes, would discourage concentration of wealth, thereby preserving economic opportunity and the free enterprise system. If tax shelters were not available, a high bracket taxpayer would have to earn a higher profit to receive the same after tax return as a lower bracket taxpayer. For example, assume a 50 percent bracket taxpayer and a farmer in the zero bracket are each seeking a six percent after tax return on investment. The 50 percent bracket taxpayer would need a twelve percent before tax return, while the 0 bracket farmer would need only a six percent before tax return.

However, tax shelters must be avoided because they reverse the impact of progressive taxation and subsidize concentration of wealth. For example, if tax rules understate gross income by 12 percent, a 50 percent bracket investor can garner a six percent after tax return on an investment which breaks even before taxes. To get the same after tax return the 0 bracket farmer would need a six percent farm profit. High bracket taxpayers can make money by losing money where artificial losses claimed for tax purposes create tax savings greater than true economic losses.

A neutral and shelter free tax system which measures incomes accurately would eliminate advantages gained by high bracket taxpayers over moderate sized and beginning farmers. With tax subsidies to capital investment eliminated, there would be a more efficient mix of capital and labor and room for people in agriculture. The number of farmers would be more stable. Investments would be made on the basis of efficiency, profitability and productivity, rather than tax considerations. Consequently, supplies of farm products would be more in line with demand, and land prices would be less volatile and more in line with land's income earning potential.

BEFORE TAX PROFITS NEEDED TO GENERATE SIX PERCENT AFTER TAX RETURNS BY BRACKET

No Tax Shelter		Tax Shelter - Gross Income 12% Understated	
0 Bracket	50% Bracket	0 Bracket	50% Bracket
6%	12%	6%	0%

Tax Rate Reductions and Increase in the Personal Exemption

For a farm family of four, the first $12,000 of income would be tax exempt, income from $12,000 to $37,000 would be taxed at 15 percent, income from $37,000 to $78,000 at 25 percent, and income over $78,000 at 35 percent. The first $25,000 of corporate income would be taxed at 15 percent, the second $25,000 at 18 percent, the third $25,000 at 25 percent, and income over $75,000 at 33 percent. The low rates on the first $75,000 of income would be phased out and recaptured for corporations with taxable income over $140,000.

Taxes would be redistributed. Corporations would carry a little more of the burden than under current law but still pay less than one fifth of the bill. Individuals would pay less as a group, particularly the poor and rich. Persons with incomes of over $200,000 per year would average a ten percent tax reduction compared to seven percent for middle income taxpayers.

Farm Impact - Because modest income taxpayers would pick up a bigger share of the individual tax burden, relative to the rich, they would be weakened as economic competitors. High income taxpayers would hold on to more of their income, allowing them to buy more land and other farm assets, though the lower top rate may reduce investments made primarily for tax reasons. Large corporations would have slightly less money left after taxes to invest in farming. Large farmers and high income investors would continue to avoid the progressivity of individual tax rates by incorporating. For example, a family with a large incorporated farm with a $74,000 net income would pay the same average tax rate (10.14 %) as an unincorporated farm family with half the income. If the family's large farm earned $100,000 per year, its average tax rate would rise only to 12.25 percent. These large incorporated farmers would continue investing corporate income in rapid expansion, to avoid paying it out in double taxed dividends. Thus these large farms would be tax subsidized to absorb land and markets that would otherwise be available to moderate sized and beginning farmers.

AVERAGE TAX RATES FOR LARGE INCORPORATED FARMS AND A SMALL FARM PROPRIETOR*

	Farm Proprietor		Incorporated Farms			
	$37,000 Income		$74,000 Income		$100,000 Income	
	Income	Tax	Income	Tax	Income	Tax
Personal Income	$37,000	$3,750	$37,000	$3,750	$37,000	$3,750
Fringe	00	00	$12,000	00	$12,000	00
Corporate Income	00	00	$25,000	$3,750	$51,000	$8,500
Total	$37,000	$3,750	$74,000	$7,500	$100,000	$12,250
Average Tax Rate	10.14%		10.14%		12.25%	

This assumes families of four and that each corporation employs its primary stockholder for $37,000 per year. Each corporation deducts $12,000 for providing fringe benefits to its employee stockholder including $6,500 of depreciation and $1,500 of taxes on a one year old $160,000 home, and $4,000 of home, health and life insurance.

Investment Tax Credit and Accelerated Depreciation

The investment tax credit would be eliminated. There would be six depreciation classes, including a four year category for pickups and cars; five years for trucks and trailers; six years for tractors, seven years for farm equipment, bins, silos and confinement buildings, and 28 years for machine sheds, houses, and general purpose buildings. Current law places cars and pickups in a three year category; farm equipment, confinement buildings and bins in a five year category; and general buildings in an 18 year category. The longer depreciation terms are misleading however; depreciation for farm equipment and confinement buildings would be 22 percent more valuable than the current five year writeoff. Tractor writeoffs would be 29 percent more valuable (assuming five percent inflation/12% interest). That is because the President proposes adjusting the deductions upward for inflation. For example, the deduction in year five of a tractor's life would be increased by 25 percent if inflation had been 25 percent over the five years (less than five percent annually) since it was purchased. We compare the present value of depreciation deductions by use of present value analysis.* A dollar of future tax savings is not worth a full dollar today, because there is an interest cost of waiting for the money.

VALUE OF $100 OF DEPRECIATION ASSUMING 5% INFLATION/12% INTEREST/35% BRACKET

CURRENT LAW		REAGAN PROPOSAL		
Tractors, Equipment, Confinement	General Buildings	Tractors	Equipment, Confinement	General Buildings
$23.65*	$15.58	$30.52	$28.92	$16.22

The Reagan depreciation system would be more lucrative, relative to the current system, during high inflation. Deductions on a tractor would be more valuable to a 35 percent bracket taxpayer than the current depreciation deductions and the investment credit combined, if inflation rises to 10 percent and the interest rate is 15 percent.

Family Farm Impact - In most cases, the total incentive to increase production, enlarge farms and replace labor with capital would be slightly reduced. In the long run, that would result in slightly better prices for farm commodities; especially for livestock, dairy and poultry products; a more efficient mix of capital and labor; and slower growth in farm size.

However, the depreciation increases would shift competitive position in favor of high bracket taxpayers. Under current law, the combined investment credit and depreciation deductions on a $40,000 tractor are worth $5,406 more to the 35 percent bracket taxpayer than the 15 percent bracket taxpayer. That advantage would increase to $6,976 under the Reagan proposal. That is due to the shift from subsidizing capital through a credit, the value of which does not depend on tax bracket, to subsidizing capital through a deduction which is of more value the higher the bracket.

* (Present Value = Future Value / (1 + Interest Rate)$^{\text{Number of Years}}$. Depreciation deductions are reduced by 5% (half of the investment credit) under current law.

VALUE DEDUCTIONS/CREDITS $40,000 TRACTOR/12% INTEREST/5%INFLATION/35% BRACKET

	Current Law	Reagan Proposal
35% Bracket	$13,461	$12,209
15% Bracket	$8,055	$5,233
Greater Savings Received By 35% Over 15% Bracket	$5,406	$6,976

The continued treatment of single purpose agricultural structures as equipment, is in violation of Treasury's goal of neutrality between assets. Under current law, the effective tax rate on investment in single purpose structures is less than 60 percent of that for farm machinery, and 44 percent of that for multipurpose structures; for a 50 percent bracket taxpayer (Effective Income Tax Rates For Farm Capital, 1950 - 1984, Economic Research Service, USDA). The resulting over investment lowers long term total profits (The Influence of Federal Tax Policies and Other Forces On the Structure of the Farming Industry and the Hog Production Industry, Luther Tweeten, Agricultural Economics, Oklahoma State University). The tax advantage of investing in single purpose structures would be increased relative to farm machinery by the Reagan proposal to replace investment credit subsidies, which favor assets with short useful lives, with a more lucrative depreciation system. The result would be continued over investment, over production and low profits in the hog, poultry and dairy industries. Corporate and nonfarm investment would continue as high bracket large scale operations would continue to be granted a competitive advantage over moderate scale/income producers. Placing confinement buildings in the equipment category, rather than the structure category, would reduce their after tax cost to the 35% bracket investor by $139.79 per sow capacity; over 2.5 times the benefit to a 25% bracket established farmer and seven times the benefit to a 15 percent bracket low equity beginning farmer. The tax code would continue to facilitate the concentration of livestock, dairy and poultry production into fewer hands, at the expense of moderate sized and beginning farmers.

VALUE OF DEPRECIATING HOG BUILDINGS AS EQUIPMENT INSTEAD OF STRUCTURES PER SOW*

	20% Bracket, 40 Sow Beginning Farmer	25% Bracket 100 Sow Farmer	33% Bracket Large Corporate Operation	35% Bracket Investor 500 Sow Unit
Depreciation Value - Equipment Category	$46.49	$123.96	$272.71	$318.16
Depreciation Value - Structure Category	$26.06	$69.50	$152.89	$178.37
Net Value Equipment Category Placement	$20.43	$54.46	$119.82	$139.79

Business Interest Deductions

Business interest would be deductable as under current law, rather than indexed for inflation as under the initial Treasury Plan. Deduction of nonbusiness interest, interest incurred as a limited partner, and interest incurred as a stockholder in a Subchapter S corporation in which the taxpayer is not involved in management, would be limited to $5,000 per joint return plus net investment income. This would seldom prevent nonfarm investors from deducting interest. Those who invest as sole proprietors, general partners or as stockholders in regular corporations would be unaffected. They could also invest as stockholders in Subchapter S corporations if they participate in management, which is not defined in the President's proposal. Presumably, that requirement could be met by participating in basic decisions about the farm operation (such as crops to be grown) and taking some risk, such as through a share rental.

Family Farm Impact - Nonfarm investors would avoid the limitations. In the initial years of farm investments, the proprietorship, general partnership, or if active in management, Subchapter S corporate structure would be used to pass upfront losses through to personal returns. When upfront losses are exhausted, investments would be structured as regular corporations to enjoy their low tax rates on the first $75,000 of income. The interest deduction limitations would not apply to regular corporations.

Because interest deductions would not be indexed for inflation, higher bracket borrowers would continue to enjoy lower real after tax interest rates than low bracket taxpayers. That is because the Reagan proposal would allow deduction of more than the real cost of borrowing money, as does current law. The true cost of borrowing money is less than interest paid because during inflation we repay loans with cheaper dollars than we borrowed. The real interest rate is the market interest rate minus inflation. In times of high inflation, the real after tax cost of borrowing money can be zero or negative for high bracket taxpayers - they save more by deducting high interest payments than the real cost of borrowing money. Yet, those with low or no tax liabilities pay the full cost. Furthermore, when high income taxpayers can borrower at low or negative interest rates,

*The hog building example assumes the 500 sow investor-owned unit qualifies $550,000 worth of structure, excluding equipment, amounting to $1,100 per sow. The 5,000 sow corporate operation qualifies $1,100 per sow. The 25 percent bracket, 100-sow producer qualifies $60,000 worth of structure, excluding equipment, amounting to $600 per sow. This includes $28,000 for a 20 crate farrowing house, $7,000 for a partially owner constructed solar modified open front nursery, and $25,000 for a partially owner constructed modified open front finishing house. The 15 percent bracket, 40 sow beginning farmer qualifies $15,000 for acquisition and remodeling of some older barns, excluding equipment, costing $375 per sow. These assumptions were developed with the assistance of industry and land grant university personal, as representative of significant groups of producers. The lower investment levels for smaller producers reflects the trade off between capital and labor; smaller farmers invest more of their labor and less capital in raising hogs, especially low equity beginning farmers. We assume 12 percent interest and five percent inflation.

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they borrow more and drive up interest rates for everyone. Conversely, savings are discouraged because savers are taxed on all of the interest they receive, which is less than their real return because they're repaid with less valuable dollars than they put into savings. The penalty is more severe for higher bracket taxpayers. This contributes to a shortage of loanable funds which also drives up interest rates. The resulting high interest rates are devastating to lower income taxpayers who cannot recover interest through tax savings. High income taxpayers are granted a competitive advantage in borrowing to buy and control more of the country's productive wealth and are discouraged to save. The result is greater concentration of farm assets in fewer hands.

REAL AFTER TAX INTEREST RATES BY TAX BRACKET

Tax Bracket	0%	15%	25%	35%
Real After Tax Interest Rate (Assuming 5% Inflation and 12.5% Interest)	7.5%	5.6%	4.4%	3.1%
Real After Tax Interest Rate (Assuming 10% Inflation and 15% Interest	5%	2.8%	1.3%	-.3%

CAPITAL GAINS EXEMPTION

The capital gains exemption would be reduced to 50 percent, from 60 percent, and would no longer apply to depreciable property such as breeding stock and equipment. Thirty five percent bracket taxpayers would pay an effective tax rate on capital gains of 17.5 percent (.50 x .35), compared to 20 percent for high bracket (50%) taxpayers under current law. The corporate capital gains rate would remain at 28%. Beginning in 1991, taxpayers would have the option of indexing gains for inflation in lieu of the capital gains exemption. In other words, only gains beyond the general rate of inflation would be taxed, but they would be taxed as ordinary income. As under current law, the gain on property held or passed on to heirs would be untaxed.

Family Farm Impact - The reduction in the effective capital gains rate for high income individuals would encourage speculative investments in farmland. High income people would retain more income after taxes with which to accumulate more of the nation's farmland, at the expense of moderate sized and beginning farmers. Income made by land speculation would be tax favored relative to income made by farming. Because gains on property held or passed on to heirs would be untaxed, the tax code would continue to facilitate the concentration of farmland in fewer hands, including wealthy farm families, corporations and investors. The capital gains exemption would continue to inflate land prices during the good times as investors anticipate tax favored appreciation, raising the cost of production for farmers, forcing the nonwealthy out of the land market and laying the groundwork for land price crashes.

However, elimination of the capital gains exemption on breeding and dairy stock would strengthen the competitive position of family farmers and ranchers. The incentive for high bracket taxpayers to use inefficient practices, such as using swine breeding stock for only one litter, (The All Gilt Breeding Herd--More After-Tax Profits?, Michael Duffy and Larry Bitney, Department of Agricultural Economics, University of Nebraska), would be eliminated. Because the capital gains exemption makes every breeding animal a tax shelter leading to over expansion of the herd, its elimination would improve long run profitability and reduce pressure on the dairy price support program. The change would benefit most cow/calf producers if it resulted in a $.02 calf price increase. Most dairy farmers would benefit if the change resulted in an $.09 per cwt. milk price increase together with a $.02 per pound increase in the price of steer and bull calves. For higher income taxpayers, however, the loss of the exemption would be more costly.

CALF PRICES INCREASES OF GREATER AFTER TAX BENEFIT THAN 50% CAPITAL GAINS*

TAX BRACKET	0%	15%	25%	35%
	$.01	$.02	$.03	$.05

MILK AND CALF PRICE INCREASES OF GREATER AFTER TAX BENEFIT THAN CAPITAL GAINS*

TAX BRACKET	0%		15%		25%		35%	
	MILK	CALF	MILK	CALF	MILK	CALF	MILK	CALF
	$.01	$.01	$.09	$.02	$.17	$.03	$.28	$.05

Cash Accounting and Preproductive Period Expenses

Cash accounting could not be used by farms of over $5 million sales. Corporations with over $1 million sales are already prohibited from using cash accounting, with the exception of Subchapter S corporations and family owned corporations. Expenses of raising dairy heifers, stock cows, and orchards would be depreciated. This would not affect hogs or sheep. Farmers would have the option of deducting the cost of raising replacement stock and adding them to inventory. Under current law, taxpayers who use cash accounting can deduct the cost of developing most orchards and raising replacement dairy and breeding stock; and do not place them in inventory. (Cash accounting allows mismatching of expenses and receipts from year to year by ignoring inventories in determining net income. Taxpayers generate artificial losses and defer taxation by deducting this year costs of producing crops or livestock to be sold in following years. Tax deferral is

*For the cow calf producer, we assume a 15 percent annual culling rate, 800 pound cows sold for $400, and a 90 percent calf crop sold at 400 pounds. We consider the portion of additional income from higher prices which would be paid in income taxes, in determining the price increase necessary to improve after tax income. *For the dairy, we assume cull cows sold for $500, with an average life in the herd of 3.25 years and production of 12,000 pounds of milk per year; and a 45 percent bull calf crop sold at 400 pounds. The increased calf and milk prices added together would yield greater after tax benefits to the dairy than the capital gains exemption.

equivalent in value to an interest free loan. The savings are greatest for expanding farms, because income invested in growing inventories is sheltered from taxation).-

Family Farm Impact - Breeding Stock, Dairy and Orchard Changes - Low bracket farmers would be strengthened as competitors relative to high bracket taxpayers. Production of calves, milk, fruit and nuts would be lower, resulting in better prices received by producers. Citrus and almond growers successfully sought similiar treatment of citrus and almond groves in the late 1960s to counter over planting of orchards by investors. As a result, they have received better prices for their products. Valencia orange and lemon production for 1985 will be 27% lower as a result of the change (The Taxing Effects of Tax Reform Hoy Carman, Professor of Agricultural Economics, University of California, Davis). The proposed change would have a similiar effect on milk and calf prices, because current law provides strong incentives to expand the herd. Income invested in raising a heifer to add to the herd is untaxed until the herd is dispersed. Expanding the herd by one $500 cow shelters $500 from taxation indefinitely. Producers can virtually eliminate taxation by expanding their herds rapidly. While that is attractive to farmers from a tax stand point, it virtually assures interest in dairy and breeding stock tax shelters and chronic over production/low profits.

CASH ACCOUNTING SUBSIDIES PER $500 COW ADDED TO THE HERD

TAX BRACKET	0%	15%	25%	35%
	0	$75	$125	$175

Implementation of this change could create transition problems, because income currently tied up in cows and orchards would be taxed. The transition would be phased in over six years.

Family Farm Impact - General Cash Accounting Provisions - Nonfarm investors would continue to use cash accounting to shelter income from taxation by feeding cattle and hogs. Cattle feeding would continue its movement into custom lots feeding for tax motivated investors, as lower bracket feeders would continue to be bid out of the feeder cattle market. Tax shelter cattle feeding would continue to stimulate high beef production and low fat cattle prices. Cash accounting would continue to subsidize farm size expansion, contributing to land price volatility and reducing opportunity for moderate sized and beginning farmers. Cash accounting would still grant a competitive advantage to high bracket taxpayers over low.

However, very large family owned corporations which currently may use cash accounting would lose the privilege, weakening their competitive position relative to modest income, moderate sized and beginning farmers. Likely examples include, in cattle feeding, Foxley and Monfort corporations; in poultry, Perdue Chicken; and several of the nation's largest contract hog producers including Plainview Hog, Dick Van Lunen, and Carroll Foods. The change would slow future expansion by such firms, increasing long term profits.

DEDUCTIONS FOR LAND CLEARING, CONSERVATION AND LIMING

Costs of land clearing, leveling, draining, liming, shaping, terracing, planting of wind breaks, etc. would no longer be deductable. Rather such costs would be capitalized and depreciated, or if the improvements have infinite lives, deducted from capital gain upon sale of the land.

Family Farm Impact - The after tax cost of conservation improvements would be higher. Fewer terraces, windbreaks, etc. would be installed. This would result in a long term erosion increase on some land already in production, relative to current law. However, incentives to bring new marginal land into production would be reduced. The loss of these deductions would slow the conversion of woodlands, where the deduction for tree clearing would be lost; wetlands, where the deduction for drainage would be lost; and rough rangeland, where the deduction for land shaping and knocking down ridges would be lost. Because these deductions are of more value the higher the tax bracket, moderate income farmers would be strengthened as competitors for affected land. Because these deductions are dependent on converting land to crop production, purchasers who keep land in conserving uses (pasture, woodlots, etc) and currently receive no benefit, would be strengthened as competitors.

PER ACRE SUBSIDY FOR CLEARING ARKANSAS BOTTOMLAND, UNDER CURRENT LAW*

TAX BRACKET	0%	15%	25%	35%
	0	$46.50	$77.50	$108.50

SUBSIDY TO BULLDOZING RIDGES FOR CONVERSION OF NEBRASKA SANDHILLS RANGELAND*

TAX BRACKET	0%	15%	25%	35%
	0	$7.50	$12.50	$17.50

INCOME AVERAGING

Income averaging would be repealed.

Family Farm Impact - Eliminating income averaging would increase the disparity between taxpayers with volatile incomes, such as farmers, and taxpayers of equal economic well being with more stable incomes. Without income averaging a farmer with a family of four whose income alternates between 0 and $60,000 would pay $8,200 more tax over four years than a family of four of equal economic well being with a steady $30,000 annual

*The woodland example assumes clearing costs of $310 per acre, the investment cost for bottomland clearing in Eastern Arkansas in Spring of 1978 for the most productive soil type (Economic Incentives for Bottomland Conversion: The Role of Public Policy and Programs, Leonard Shabman, Agricultural Economics, Virginia Tech University). The Sandhills example assumes rough land with shaping costs of $50 per acre.

income. The disparity would be reduced to $6,100 with income averaging. However, to the extent that income averaging is used by people with rapidly rising, rather than up and down incomes, its elimination would shift burdens to high income taxpayers and weaken them as competitors for land and other farm assets, relative to moderate income taxpayers.

TAXES ON CONSISTENT INCOMES VERSUS VOLATILE INCOMES, WITH/WITHOUT AVERAGING

INCOME	$30,000 PER YEAR	INCOME ALTERNATING BETWEEN $60,000 AND 0 WITH AVERAGING	WITHOUT AVERAGING
TAX OVER FOUR YEARS	$10,800	$16,700	$19,000

ALCOHOL FUELS CREDIT

The $.60 per gallon alcohol fuels credit would be eliminated for fuel produced in plants completed after 1985. The credit would be eliminated on fuel produced in existing plants on January 1,1993.

Family Farm Impact - Future demand for grain and grain prices would be reduced. Future increases in acreage devoted to grain production would be slowed, reducing soil erosion.

AGGIE BONDS

Aggie bonds, federally tax exempt bonds for farm finance, would be eliminated as would all other nongovernmental tax exempt bonds.

Family Farm Impact - A lower cost source of credit would be lost to first time land buyers, and for purchase of new machinery. However, tax exempt bonds are a terribly inefficient and sometimes counter productive way to help family farmers. Over half of the subsidy goes to the bond companies and investors who buy bonds. Furthermore, such loans are often poorly targeted. Although land loans are limited to first time landowners, sons and daughters of very wealthy landowning families may receive loans to add to family land holdings, which subsidizes land concentration. Machinery and facility loans are largely limited to new property, so low equity farmers who must buy used machinery need not apply. There are no eligibility guidelines on aggie bond finance of depreciable property. They've been used to finance investor owned corporate hog operations. This results in lower hog prices, reduces family farm profits, and facilitates concentration of agriculture into fewer hands. There is a need for carefully targeted, low interest credit in agriculture, but it would be better provided through the Farmers Home Administration.

WATER DEPLETION ALLOWANCE

The water depletion allowance would be retained.

Family Farm Impact - The tax code would continue to subsidize depletion of aquifers. This would continue the advantage granted to high bracket taxpayers over low and to those who mine water over those who conserve it.

WATER DEPLETION TAX SAVINGS ON A HOLT COUNTY NEBRASKA 132 ACRE CIRCLE*

Conserving Farmer/Rancher Withdrawing Water At Its Recharge Rate	15% Bracket Farmer 1% Annual Depletion	35% Bracket Taxpayer 1% Annual Depletion
0	$108.90	$254.10

ALTERNATIVE MINIMUM TAX

The purpose of the alternative minimum tax is to assure that taxpayers who make extensive use of shelters pay some tax. In affect, the President's minimum tax would require a tax of at least 20 percent; with capital gains deductions, depreciation in excess of depreciation in the initial Treasury tax plan and several other breaks unrelated to farming added back in income. However, a family of four need not add in their first $33,000 of tax shelter deductions, plus itemized deductions. For the home owning family of four with $17,000 of itemized deductions, the first $50,000 of tax shelter deductions would not be covered. The taxpayer would owe the alternative minimum tax or the regular tax, whichever is greater. Many farm tax shelters such as cash accounting, interest deductions, and the value of depreciating confinement buildings as equipment would not be affected.

Family Farm Impact - Insolvent farmers forced to sell land would still often face large alternative minimum tax bills, even though they are bankrupt. Many farm tax shelters would continue unaffected. Even those covered would still be used to create large tax savings and to lower the effective tax on high bracket incomes well below the statutory rate.

CORPORATE MINIMUM TAX

The corporate minimum tax would be similiar to the alternative minimum tax for individuals, except that the exempt amount of tax sheltered deductions would be $25,000. In addition, the tax would apply to some interest deductions.

Family Farm Impact - Many farm tax shelters would continue unaffected. Even those covered would still be used to create large tax savings and to lower the effective tax well below the 33 % statutory corporate rate.

*The water depletion example assumes that underground water adds $550 per acre to the value of the land, based on 1980 Sandhills land values.

INC COMMUNICATING FOR AGRICULTURE

Law Office Building
P.O. Box 677
Fergus Falls, Minnesota 56537-9990

Phone (218) 739-3241

TESTIMONY FOR THE U. S. SENATE COMMITTEE
ON FINANCE

THE IMPACT OF THE ADMINISTRATION'S TAX REFORM AND SIMPLIFICATION PLAN
ON AGRICULTURE, TIMBER AND SMALL BUSINESS

JULY 10, 1985

SUBMITTED FOR THE RECORD BY:

N. Rollie Lake
President
Communicating for Agriculture, Inc.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS N. ROLLIE LAKE AND I AM PRESIDENT OF COMMUNICATING FOR AGRICULTURE. I AM PLEASED TO HAVE THIS OPPORTUNITY TO SUBMIT TESTIMONY TO THE SENATE COMMITTEE ON FINANCE TO DISCUSS THE IMPACT OF THE ADMINISTRATION'S TAX REFORM AND SIMPLIFICATION PLAN ON AGRICULTURE, TIMBER AND SMALL BUSINESS.

THE ADMINISTRATION'S PROPOSAL TO SIMPLIFY THE CURRENT TAX CODE IS CERTAINLY ONE OF THE MAJOR ISSUES NOW UNDER CONSIDERATION BY THE 99TH CONGRESS, AND IS A KEY CONCERN OF AGRICULTURE NATION-WIDE. ANY TAX SIMPLIFICATION PROPOSAL MAY, IF ENACTED, SIGNIFICANTLY ALTER THE FINANCIAL OUTLOOK OF AMERICAN FAMILY AGRICULTURE. IT IS THEREFORE ESSENTIAL THAT MEMBERS OF THE AGRICULTURAL COMMUNITY HAVE THE OPPORTUNITY TO EXPRESS THEIR OPINIONS ON HOW THEY BELIEVE THEY WOULD FARE UNDER TAX REFORM BEFORE IT IS PUT IN PLACE. WE COMMEND YOU FOR PROVIDING THAT OPPORTUNITY.

TODAY, I WOULD LIKE TO DISCUSS TWO ELEMENTS OF THE ADMINISTRATION'S TAX SIMPLIFICATION PROPOSAL: THE IMPACT OF AGRICULTURAL TAX STRUCTURES ON FAMILY FARM AND RANCH OPERATIONS AND THE RELATIONSHIP OF INDUSTRIAL DEVELOPMENT BOND FINANCING AND THE RELATIONSHIP TO BEGINNING FARMER PROGRAMS.

THE OVERALL TAX SYSTEM IN AGRICULTURE IS OF TREMENDOUS CONCERN. ACCORDING TO AGRICULTURE ECONOMIST DR. HAROLD BREIMYER

OF THE UNIVERSITY OF MISSOURI, "THERE IS NO CHANCE TO PRESERVE FAMILY FARMING IF TAX RULES ARE NOT CHANGED. THERE'S NO POINT IN EVEN TRYING UNLESS THE TAX MATTER IS ADDRESSED AND CORRECTED."

THE PRESENT TAX SYSTEM IS NOT FAIR BECAUSE IT FAVORS THOSE WHO HAVE OFF THE FARM INCOME WHICH IS SHELTERED BY FARMING AND RANCHING OPERATIONS. BOTH THE PART TIME OPERATOR AND THE LARGE CORPORATE OPERATOR CAN SAVE TAX DOLLARS BY SHELTERING OFF THE FARM INCOME IN THEIR FARM OR RANCH OPERATION.

THEREFORE, CA SUPPORTS TARGETING ALL PROPOSED TAX CODE CHANGES TO PROTECT FAMILY FARM AND RANCH OPERATIONS. PRESENT TAX CODE HAS FOSTERED THE GROWTH OF VERY LARGE AND PART TIME FARM AND RANCH OPERATIONS AT THE EXPENSE OF FAMILY SIZE FARM AND RANCH OPERATIONS.

TO AGAIN QUOTE HAROLD BREIMYER, "THE FAMILY FARM IS ON THE PATH TO OBLIVION. IT IS HEADED THAT WAY FOR REASONS HAVING LITTLE TO DO WITH ITS GREAT RECORD OF PERFORMANCE. IT IS BEING KILLED BY TWO NATIONAL POLICIES. ONE IS TIGHT MONEY MONETARISM. THE OTHER IS THE INCOME TAX CODE."

ONE OF THE BIGGEST PRESSURES AGAINST FAMILY FARM AGRICULTURE IS THE PRESENT TAX CODE. ALL SHELTERED INVESTMENT IN AGRICULTURE HAS A COMPETITIVE ADVANTAGE OVER THE UNSHELTERED INVESTMENT. AS TAX SHELTERS IN AGRICULTURE HAVE BECOME MORE AND MORE ATTRACTIVE TO OUTSIDE INVESTORS, IT HAS BECOME MORE AND MORE DIFFICULT FOR FAMILY FARMERS TO COMPETE. IT IS DIFFICULT FOR FARMERS WHOSE

PRIMARY OR SOLE SOURCE OF INCOME IS FROM FARMING TO COMPETE WITH THOSE INVESTORS WHO ARE NOT INTERESTED IN MAKING A PROFIT FROM THEIR FARM OPERATIONS.

FOR THESE REASONS, CA BELIEVES THAT THE TAX SHELTERS AVAILABLE IN AGRICULTURE SHOULD BE LIMITED TO FAMILY FARMERS AND RANCHERS AND NOT AVAILABLE TO OUTSIDE INVESTORS. CA PROPOSES THAT THE BENEFITS BE TARGETED TO COMMERCIAL FAMILY FARMERS WITH GROSS ANNUAL SALES BETWEEN $40,000 TO $200,000. IF BENEFITS ARE NOT TARGETED AND THE ADMINISTRATION'S TAX REFORM PLAN IS ADDED, MOST FAMILY FARMERS WILL PAY MORE IN FEDERAL TAXES.

THE ADMINISTRATION'S PLAN WOULD ELIMINATE THE INVESTMENT TAX CREDIT. THIS WOULD ADD TO THE TAX DOLLARS PAID BY FAMILY FARMERS AND RANCHERS AND WILL RESULT IN LESS CAPITAL INVESTMENT IN FARM AND RANCH OPERATIONS.

THE ADMINISTRATION'S TAX PLAN WOULD CHANGE THE CAPITAL GAINS TAX STRUCTURE. IT WOULD ELIMINATE BREEDING STOCK FROM THE CAPITAL GAINS TAX. THIS WILL CERTAINLY HURT ALL FAMILY LIVESTOCK OPERATIONS. TODAY, FROM TWENTY TO FORTY PERCENT OF ALL FAMILY LIVESTOCK INCOME IS FROM THE SALE OF BREEDING STOCK. THIS IS INCOME WHICH HAS CERTAINLY HELPED THE NET PROFIT OF FAMILY FARMERS AND RANCHERS WHO HAVE LIVESTOCK OPERATIONS INVOLVING BREEDING STOCK.

IN ADDITION, THE ADMINISTRATION'S TAX PLAN WOULD AFFECT THE SALE OF OTHER FARM ASSETS. IT WOULD CHANGE THE AMOUNT OF CAPITAL

GAINS FROM FORTY TO FIFTY PERCENT, THEREBY INCREASING TAXABLE INCOME FOR FAMILY FARM AND RANCH OPERATIONS.

THE ADMINISTRATION'S TAX PLAN WOULD CHANGE DEPRECIATION SCHEDULES, THEREBY SPREADING THE CHARGEABLE COSTS OVER MORE YEARS. THIS AGAIN DECREASES ANNUAL EXPENSES FOR THE FAMILY FARM OR RANCH OPERATION AND ADDS TO THE TAXABLE INCOME. HERE AGAIN, IT WILL ONLY HAVE THE EFFECT OF CREATING LESS OF A PROFIT FOR OUR FAMILY FARM AND RANCH OPERATIONS.

ANOTHER OF THE CHANGES IN THE ADMINISTRATION'S TAX PLAN IS ONE WHEREBY FERTILIZER EXPENSE AND WATER AND SOIL CONSERVATION EXPENSE WOULD GO FROM THE YEAR OF PURCHASE OR PAYMENT TO THE YEARS OF BENEFITS. THIS CHANGE LOWERS ANNUAL OPERATING EXPENSE THEREBY AGAIN ADDING TO THE TAX DOLLARS PAID. FERTILIZER AND CONSERVATION EXPENSES ARE ONE TIME EXPENSE PAID ITEMS AND NOT PAYMENTS OVER YEARS OF BENEFITS, THEREFOR, THEY NEED TO BE TAXED ACCORDINGLY.

THE PRESIDENT'S TAX PROPOSAL ALSO ELIMINATES THE USE OF INCOME AVERAGING AS A WAY OF LEVELING OUT GOOD AND POOR YEARS. WITHOUT THE TAX ADVANTAGE THAT INCOME AVERAGING GIVES THE FARMER OR RANCHER, THERE WOULD BE A NEED TO SELL COMMODITIES AT THE WRONG TIME JUST TO LEVEL OUT TAXES PAID.

THE PRESIDENT'S TAX PROPOSAL CALLS FOR THE ELIMINATION OF STATE AND LOCAL INCOME TAXES FROM THE OPERATING EXPENSE, AGAIN CREATING AN ADDED EXPENSE TO THE FAMILY FARM OR RANCH OPERATION.

COMMUNICATING FOR AGRICULTURE BELIEVES THAT ANY PROGRAMS RELATING TO AGRICULTURE, AND ANY BENEFITS GOING TO AGRICULTURE SHOULD BE TARGETED TO THE FAMILY SIZE FARM AND RANCH OPERATION AND NOT FOR THE BENEFIT OF THE OFF THE FARM INVESTOR. CA MAKES THE FOLLOWING RECOMMENDATIONS TO ANY PROPOSED TAX CHANGES. FIRST, CA FEELS THAT ANY VALID BENEFITS THROUGH SUBSIDIES, ASCS PAYMENTS, STORAGE FEES, ETC. SHOULD HAVE A DOLLAR LIMIT ON THEM, WHEREBY THE FIRST $200,000 IN TOTAL FARM INCOME WOULD HAVE BENEFITS. ANYTHING ABOVE THAT WOULD RECEIVE NO GOVERNMENT-BENEFITS. ADDITIONAL TARGETING OF FARM AND RANCH OPERATIONS WOULD CONSIDER ANNUAL FARM GROSS INCOMES BETWEEN $40,000 AND $200,000 TO BE THAT OF FAMILY FARM AND RANCH OPERATIONS.

THE LAST TARGET THAT CA CONSIDERS WOULD BE ONE WHEREBY ANY INDIVIDUAL OR FAMILY OR GROUP OF INDIVIDUALS THAT WOULD HAVE MORE OFF THE FARM INCOME THAN NET FARM INCOME WOULD AUTOMATICALLY RESTRICT THEM FROM ANY AGRICULTURAL BENEFITS BECAUSE OF THEIR FARMING OR RANCHING OPERATIONS.

THE OTHER POINT THAT WE WOULD LIKE TO MAKE IN OUR TESTIMONY IS THE TAX EXEMPT STATUS OF INDUSTRIAL DEVELOPMENT BONDS OR IDBs USED TO FUND MANY STATE AGRICULTURAL FINANCE PROGRAMS. THIS WILL END ON DECEMBER 31, 1985 IF PRESIDENT REAGAN'S TAX SIMPLIFICATION ACT IS APPROVED. IF THIS SHOULD HAPPEN, SUCH ACTION WOULD GUT IDB-BASED AGRICULTURAL LOAN PROGRAMS OPERATING IN ILLINOIS, IOWA, NEBRASKA, LOUISIANA, MONTANA, MICHIGAN, INDIANA, OHIO, COLORADO AND THIRTEEN OTHER STATES.

AGGIE BONDS HAVE BEEN USED BY STATES SINCE 1980. MOST OF THE TWENTY-TWO STATE PROGRAMS WERE ESTABLISHED BETWEEN 1981 AND 1984. WE ESTIMATE THAT MORE THAN 3,000 YOUNG FARMERS HAVE BENEFITED FROM AGGIE BONDS. IN ILLINOIS ALONE 1,200 FARMERS HAVE BEGUN THEIR OPERATIONS WITH THE HELP OF THESE TAX EXEMPT DEVELOPMENT BONDS. NATIONALLY 247 MILLION DOLLARS OF IDBs HAVE BEEN USED FOR AGRICULTURAL PURPOSES THROUGH STATE OPERATED AGRICULTURAL LOAN PROGRAMS.

CA HAS LED EFFORTS TO CREATE MANY OF THE STATE AGRICULTURAL LOAN PROGRAMS AND HAS WORKED WITH THE CONGRESS DURING THE PAST SEVERAL YEARS TO IMPROVE AND RETAIN THE USE OF TAX EXEMPT FINANCE FOR AGRICULTURAL PURPOSES. WE WERE VERY DISAPPOINTED WHEN THE TAX REFORM ACT OF 1984 WAS ENACTED TO INCLUDED A SUNSET PROVISION OF SMALL USE INDUSTRIAL DEVELOPMENT BONDS AT THE END OF 1986. WE HAVE BEEN IN REGULAR CONTACT WITH MEMBERS OF THE CONGRESS CONCERNING THIS ISSUE. THE ADMINISTRATION'S TAX PROPOSAL WOULD PUSH UP ONE FULL YEAR THE ELIMINATION OF THESE INDUSTRIAL DEVELOPMENT BONDS.

INDUSTRIAL DEVELOPMENT BOND FINANCING IS ONE OF THE MOST INNOVATIVE WAYS THAT CURRENTLY EXIST TO PROVIDE LOWER COST INTEREST LOANS TO YOUNG FARMERS. FOR THE LOWER NET WORTH BEGINNING FARMER, THERE ARE SIMPLY NOT A LOT OF PLACES HE CAN TURN. FARMERS HOME ADMINISTRATION IS NOT ABLE TO MEET THE NEEDS FOR FARM OWNERSHIP LOANS. INDUSTRIAL DEVELOPMENT BOND FINANCING FILLS A NEED AT A REASONABLE COST TO THE GOVERNMENT. IF

INDUSTRIAL DEVELOPMENT BOND FINANCING IS ELIMINATED AND NOT REPLACED BY AN ALTERNATIVE FINANCING MECHANISM, IF SOMETHING ISN'T DONE TO ASSIST OUR NATION'S QUALIFIED BEGINNING FARMERS, WE COULD LOSE A GENERATION OF FARMERS. THIS IS A SERIOUS PROBLEM.

TODAY IN AGRICULTURE, INTEREST IS ONE OF THE BIGGEST COST FACTORS. IN EXPLAINING HOW FARMERS BENEFIT FROM AGGIE BONDS, BANKER EUGENE MELI OF MC CLEAN COUNTY BANK IN BLOOMINGTON, ILLINOIS ESTIMATES, "SUCH LOANS HAVE REDUCED THE INTEREST RATE 4½ TO 5 PERCENT. THAT'S VERY IMPORTANT TODAY WITH A TIGHT CASH FLOW. ONE CLIENT SAVED $72 PER YEAR PER ACRE IN INTEREST COST."

THE USE OF INDUSTRIAL DEVELOPMENT BOND FINANCING OFFERS NO EXPOSURE TO THE FEDERAL GOVERNMENT. THE WAY THE PROGRAMS ARE CURRENTLY BEING OPERATED IN MANY OF THE STATES, THE BANKER INITIATING THE LOAN IS SOLELY AT RISK. THERE ARE NO FEDERAL OR STATE GUARANTEES STANDING BEHIND THE LOANS.

MANY PEOPLE IN THE FEDERAL GOVERNMENT HAVE ARGUED THAT THE USE OF TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS IS A SIGNIFICANT DRAIN ON THE FEDERAL TREASURY. HOWEVER, A RECENT STUDY OF THE AGRICULTURAL BANKS PARTICIPATING IN THE ILLINOIS AND IOWA PROGRAMS INDICATE THAT THE LOSS TO THE FEDERAL TREASURY IS MINIMAL. THE BANKS ARE NOT IN A HIGH ENOUGH TAX BRACKET TO NEED A TAX-EXEMPT BOND IN THEIR PORTFOLIO. THE REASON THAT THEY ARE PARTICIPATING IN THE PROGRAM IS THE OPPORTUNITY TO PROVIDE A LOWER COST LOAN TO A CUSTOMER THAT THEY COULD OTHERWISE NOT

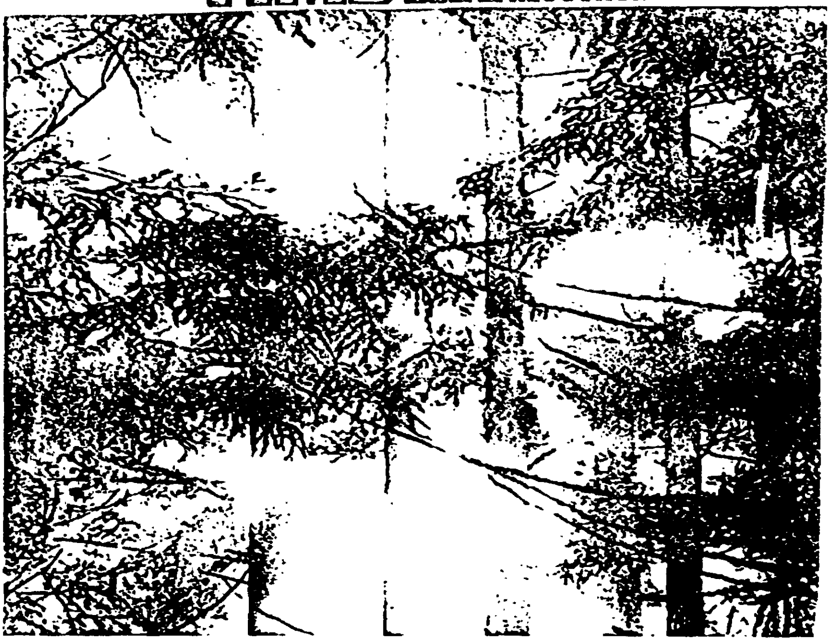
SERVE. OVERALL, AGRICULTURE HAS BEEN A MODEST AND RESPONSIBLE USER OF TAX-EXEMPT FINANCING.

TO CONCLUDE MY DISCUSSION OF THE USE OF INDUSTRIAL DEVELOPMENT BOND FINANCING IN AGRICULTURE, I WOULD URGE THAT AGRICULTURE CONTINUE TO HAVE ACCESS TO THIS SOURCE OF FINANCING BEYOND THE PRESIDENT'S PROPOSAL TO ELIMINATE IDBs IN 1985 AND BEYOND THE EXISTING SUNSET IN 1986. IT IS OF THE UTMOST IMPORTANCE THAT THE BEGINNING FARMER PROGRAMS THAT HAVE ALREADY BEEN ESTABLISHED BE ABLE TO CONTINUE AS THERE IS A GREAT NEED TO TRANSFER ONE GENERATION TO ANOTHER GENERATION.

IT IS CA'S FIRM BELIEF THAT ANY PROGRAM IN AGRICULTURE MUST BE TARGETED TO THE FAMILY FARMER. THEY HAVE BEEN THE BACKBONE OF OUR AGRICULTURAL SYSTEM, AND THE MOST DEPENDABLE SOURCE OF FOOD THE WORLD HAS EVER KNOWN. IF THE ADMINISTRATION'S TAX PROPOSAL WERE TO BE ENACTED, IT WOULD PLACE FAMILY FARMERS AT MORE OF A COMPETITIVE DISADVANTAGE THAN THEY ARE NOW EXPERIENCING. IF THE TAX CODE REMAINS UNCHANGED OR THE PRESIDENT'S PROGRAM IS ENACTED, ALL INVESTMENT IN AGRICULTURE WILL EVENTUALLY COME FROM SHELTERED SOURCES THEREBY ELIMINATING BEGINNING FARMERS AND THE FAMILY COMMERCIAL FARMER.

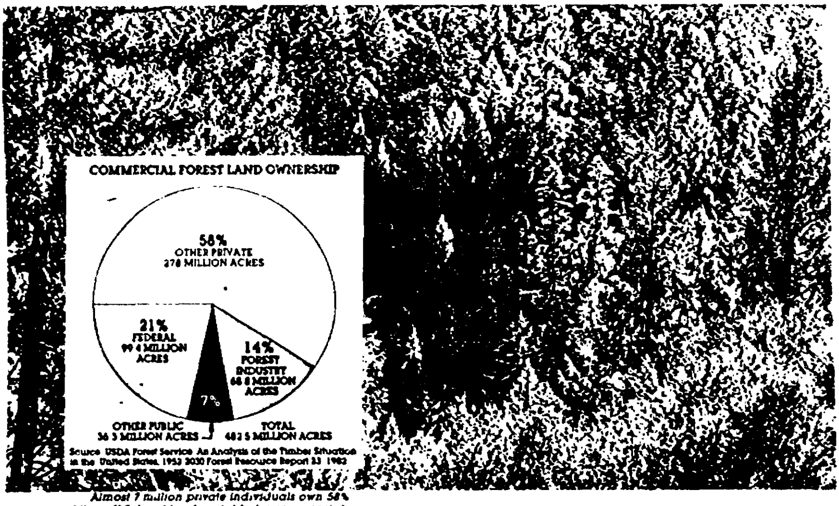
I WOULD BE HAPPY TO ANSWER FURTHER QUESTIONS ABOUT CHANGES PROPOSED BY THE ADMINISTRATION'S TAX REFORM MEASURES. THANK YOU FOR THIS OPPORTUNITY TO SUBMIT TESTIMONY TO THE COMMITTEE.

TIMBER AMERICA'S RENEWABLE RESOURCE



FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION

1330 Connecticut Avenue, N.W.
Washington D.C. 20036



Almost 7 million private individuals own 58% of those U S forest lands suitable for commercial timber production Only 14% is owned by industries engaged in forest products manufacture The remaining 28% is in public ownership

The growing and management of timber crops is a unique economic enterprise Congress long ago saw the need to provide fair and equitable taxation to those who had the enterprise and vision to invest in the long-term potential, but inherently uncertain gains of timber growing

It takes 30 to 75 years to grow timber used in the manufacture of lumber and plywood and 20 to 30 years to grow timber used for pulpwood That is why federal tax treatment for timber growing is particularly important for the tens of thousands of forest landowners who furnish the nation's timber resource

Impressive gains in planting and productivity have flowed from fair tax treatment Since 1944, when Congress enacted fair tax treatment to encourage the sustained production of trees, millions of acres have been planted and managed, reversing the earlier history of cut-and-run forestry.

Now, however, this demonstrated record of accomplishment would be threatened by recent proposals to change federal tax law These proposals would diminish our timber supply by encouraging premature timber harvest and stifling investment in forest renewal The result of this shortsighted approach to the public interest would lead to smaller supplies of timber, economic disruption, and ultimately higher prices for timber products

Today more than ever, the nation requires incentives to encourage capital investment and to reward risk Fair and consistent tax policy for forest owners is essential if we're to avoid timber scarcities and the attendant social and economic consequences

Forest entrepeneurs—from large industrial to small private owners—are found in nearly every section of the nation They are almost seven million strong and they own 347 million acres of woodlands, encompassing more than 72 percent of the commercial forest

The future of these forest owners is linked to the future needs of all Americans who seek a decent home, whose children drink from a milk carton, swing a baseball bat, or study a history book For these products and hundreds more come from the forest

Besides the major economic importance of wood and its multitude of products, the nation's forests offer watershed enhancement, habitats for wildlife, stability for soils, and incomparable opportunities for recreation and scenic enjoyment

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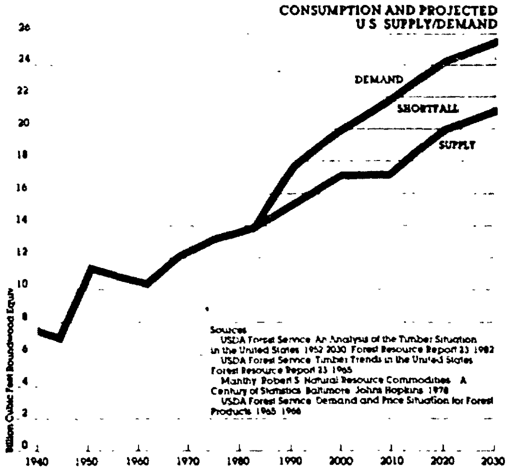

Consumer demand for forest products has been rising over the past 30 years but is expected to increase even faster between now and the year 2000

DEMAND FOR TIMBER IS OUTPACING SUPPLY

Forecasts made by the United States Forest Service, confirmed by virtually all private studies, predict that the demand for timber in the United States will rise dramatically in the next 50 years

But the supply of timber available for harvest will not be able to keep pace. Thus, the outlook for timber is, at best, one of increasing scarcity, with rising prices for both timber and timber products. The problem is particularly acute in the South, where the Forest Service believes that softwood inventories are seriously overestimated and that general shortages may occur sooner than earlier forecast

Because it takes many years to grow timber ready for harvest, the nation's total timber supply cannot respond to short-term price increases Although harvesting can be accelerated temporarily to react to a peak in demand and price, new long run supplies can only be assured by increased reforestation and management Thus, we cannot rely on short-term price and other economic fluctuations to assure long-term timber supply

Other factors affect our potential forest productivity Urban expansion, rural homesites, highway and power line construction in forest areas all reduce the total acreage available for harvest Almost 32 million acres have been withdrawn from the national forests for the Wilderness System, and more has been proposed Inadequate budgets for national forest management have further reduced the public sector share of the country's sawtimber supply

This puts a heavier burden on the roughly 72 percent of our commercial forest lands that are under private ownership to supply the nation's needs

Fortunately, the timber situation in America today would be far more serious had not many forest industry firms and private landowners had the foresight years ago, in large measure as a response to fair tax treatment, to begin forest management programs.

These programs have now reforested millions of acres of timberlands and improved the timber growth on large areas of young timber. Tree planting on private land, one of the most intensive forest management practices, has been consistently climbing

It starts here with a tiny seedling and a man's tender care. It will be fifty or more years before this Douglas fir reaches economic maturity, even with maximum protection and management.

IMPACTS ON U.S. ECONOMY AND ENVIRONMENT

Timber is a critically important resource. Government studies predict future timber supply shortages, which in turn will have a negative impact on the nation's overall economy. Resulting higher timber prices will contribute to higher costs of housing and hundreds of other consumer and industrial products.

In addition to rising prices, other impacts of timber shortages are predicted to be severe. According to the Forest Service:*

- Timber constitutes the largest base of employment and income in many rural parts of country, employing almost 2 million persons nationwide.
- "Reductions in the domestic and export markets will affect employment. Employment in the timber industries in 2030 will be nearly a hundred thousand person-year below the levels that would exist without the real price increases (now forecast)."
- Timber scarcity will have a detrimental effect on the environment. "As stumpage and timber product prices rise relative to other materials, use of substitute products such as concrete, steel, aluminum and plastic will increase. Production of these substitutes uses nonrenewable ore and fossil fuels, removing them from the country's finite store of these resources. In addition, the mining, industrial processing and power generation caused by increased use of timber substitutes will result in more air and water pollution."

To counter these impacts of declining timber inventories and rising timber prices, the U.S. Forest Service indicates that large investments in more intensive timber management programs are required to increase net annual timber growth, including development of the substantial biological opportunities that exist.

A major cooperative Forest Service and forest industry study conducted several years ago showed that intensifying management on 168 million forest acres (some 46 percent of the land in private ownership) would be required to meet our needs. Such an objective would require over $15 billion of new investment.

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*A review of the Timber Situation in the United States and the Implications for the South. United States Department of Agriculture. Forest Service (1984).

RETURNS ON TIMBER GROWING ARE MODEST

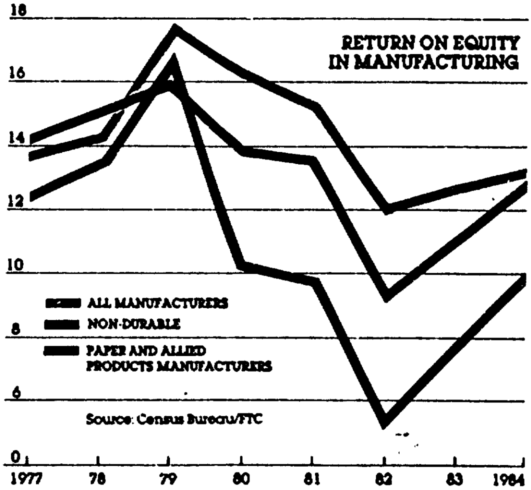
Despite the substantial success of forestry research, no miracle Jack-and-the-beanstalk trees have been found. Nor are any likely to be. Sound forest management, by the forest industry and thousands of individual owners, can accelerate timber growth substantially. But returns are limited by the relatively slow biological growth of timber as nature, not production schedules, determines forest output.

In fact, rates of return on timber growing historically have been modest. Government and private studies show that prospective returns on timber growing depend on a wide variety of factors, including site quality, local markets, and assumptions on future timber price trends. But in all regions of the U.S., they are modest at best. No one has "grown rich quick" growing timber.

On the contrary, forest industry and forestland owners have taken the brunt of recent economic recessions and the often drastic changes in government policies made in attempts to stabilize the economy. The sharp swings in demand and market prices that have accompanied past recessions highlight the risks associated with timber growing.

Rates of return on equity for timber companies have been significantly below the average of other industries. Census Bureau and FTC reports indicate the return on equity for paper and allied products for the period 1977-1984 was 11.5% compared with a return of 14.3% for nondurable goods and 13.3% for the goods of all manufacturing industries.

The importance of a strong investment climate for timber growing cannot be overstated. The forest industries are making great strides in improving management techniques to increase the viability of timber investments and to attract more capital. However, the maintenance of fair taxation for timber is essential to that investment—and to the economic well-being of the nation.



Return on timber investment is very volatile because of fluctuation in demand and price. In most years, return is below other comparable industries.

TIMBER GROWERS ALSO FACE HIGH RISKS

While rates of return are below average, the risk involved in timber growing is often higher than that encountered in other investments Unlike most assets, timber can be adversely affected by uninsurable risks e g weather, insects, disease and fire While the risk of such an occurrence may be low in any given year, over the 30- to 75-year growing period of a tree, the risk increases enormously

In recent years, fire has damaged as many as 1,400,000 acres of forest in one year.. A single hurricane has damaged more than a million acres

Forest mortality, defoliation and infestation caused by forest pests have affected as many as 23 4 million acres in a year

Although some of the timber in an affected area is salvageable, the proportion of value lost is high

It is significant that commercial insurance against fire, insect and disease losses is not available to timber owners

FAIR TAX TREATMENT IS NEEDED

Fair tax treatment of timber income is a key element assuring essential private timber investment If forest owners are sure that timber tax treatment will fully reflect the long-term, high-risk nature of their investments, more timber will be planted and produced On the other hand, if timber investments are penalized in relation to other investment opportunities, the capital so greatly needed for forest management will flow elsewhere

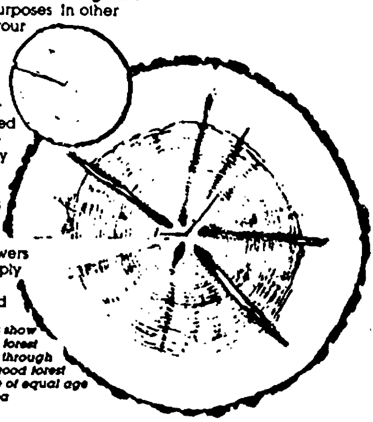
HISTORY OF U.S. TIMBER TAX POLICY

Soon after the U S Congress enacted a national income tax, the lawmakers realized that a distinction had to be made between ordinary income (wages, salaries, dividends, rent, profits) and the increase in value of long-term capital assets To do otherwise would so restrict capital mobility that innovation, productivity and national growth would suffer In 1921, a formula was adopted for taxing the gain realized when a capital asset is transferred

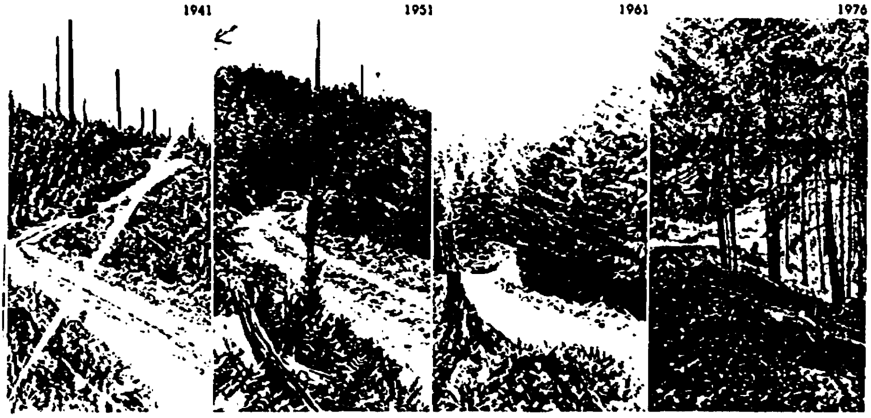
The theory behind this tax treatment was that if an investor left his money in an asset for a period of time specified by law, he was rewarded for the long-term risk taken and was allowed to keep a larger share of the growth in value he had helped to create

Timber was eligible for the capital gains rate in those earlier years, but only when liquidated or disposed of in a lump-sum sale Sustained yield timber management was not recognized for capital gains purposes In other words, if you sold your timber gradually under a cutting agreement or cut it for processing in your own mill, your proceeds were taxed at ordinary income tax rates—generally twice the rate applying to other capital transactions

In 1944, Congress changed the tax law so that growers of a continuous supply of timber would no longer be penalized



These tree sections show the results of improved forest management possible through greater investment in good forest management They are of equal age and from the same area



The timber on this land was harvested in 1941 Sound forest management is an important factor in such growth

HOW TIMBER CAPITAL GAINS WORKS

Timber is now treated similarly to other capital assets, whether sold outright, sold under contract, or processed in the owner's plant. If the statutory holding period is satisfied, the difference between the cost and sales price or the market value of the standing timber when harvested is the "capital gain" and is taxed at the long-term capital gain rate. Any value added subsequent to the harvest · from the sale of logs, the processing or marketing of forest products—is taxed at ordinary income rates

Present tax law provides that the long-term capital gain of individuals is taxed at 40 percent of the rate applicable to ordinary income The long-term capital gain rate for corporate taxpayers is 28 percent, compared with the generally applicable rate of 46 percent on ordinary corporate income. Such gain is subject to a minimum tax assessment.

HOW TIMBER OWNERS TREAT THE COST OF ESTABLISHING GROWING TREES

Timber owners are treated the same as the owners of all other assets. That is, the costs of acquiring or establishing timber are capitalized. Subsequent expenses incurred in the protection and maintenance of timber are deducted currently. Specifically, planting and reforestation costs are capitalized while fire and insect control, maintenance and silvicultural costs, interest and property taxes are deducted

WHAT THE TIMBER TAX PROVISIONS HAVE ACCOMPLISHED

Dramatic growth in private forestry management followed the 1944 enactment of the timber capital gains provisions. This more equitable tax treatment quickly fostered both increased plantings and higher productivity on private forest lands.

Prior to 1944, the United States had less timber at the end of every year than at the start. After capital gains treatment became effective, since 1944, that trend was reversed.

More than 41 million acres of private lands have been planted, compared to only 3 million acres in all previous years. Scientific forest management is now practiced in all regions of the country.

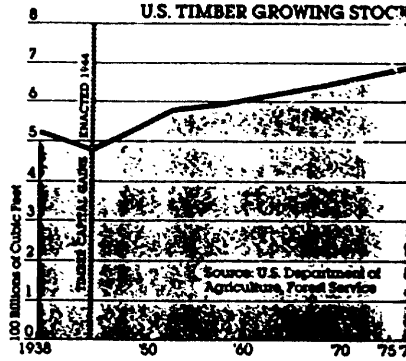
Industrial forest land ownerships have been the most responsive to the capital gains incentive. Those lands are now the most productive in the nation. Farm and other small ownerships have also shown considerable improvement in management.

Far greater economic stability exists in forest areas now than existed in earlier periods when sustained forest management was not economically feasible. Communities which in former days would have suffered economically as timber land was cut over, now can look forward to a continuing supply of raw material for local industries.

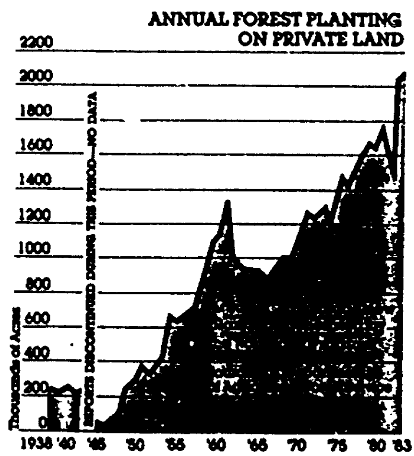
With greater industry stability and investment in new technology and equipment, a higher percentage of each harvested tree is utilized in making consumer products.

Although small lumber manufacturers experienced difficulties during the recession, generally they can be more competitive because capital gains treatment applies to the harvesting contracts which many of these manufacturers use.

Most important, the expanded forest resource made possible by the 1944 enactment of fairer timber tax laws is now available at a time when we have the greatest need for dependable raw material supplies. If these tax rules had not been enacted, the United States would already be suffering a severe crisis of wood supply.



Prior to 1944 the growing stock in United States forests declined at an average rate of 7 billion cubic feet per year. Since that time, the volume of growing wood fiber has increased until today it is approximately 195 billion cubic feet more than in 1944. This dramatic difference was made possible in large measure by the capital gains incentive to increased investments in reforestation and timberstand improvement, as well as by increased government and industry cooperation in better forestry management.



The dramatic effect of anticipated capital gains treatment of proceeds from timber growing is illustrated by the number of acres of private land planted to trees since the tax incentive was enacted in 1944. In 1980, eight acres were planted in trees for every one acre in the period preceding World War II.*

IMPORTANCE OF FUTURE TAX POLICY

Recent trends in tax policy, however, are discouraging. Although capital shortages can be as damaging to our social needs as shortages of energy or raw materials, proposals to eliminate the capital gains differential continue to surface. Yet we know that the reductions in the capital gains rates in 1978 and 1981 largely accounted for the capital formation and economic growth which has resulted since then.

It is essential to continue the inclusion of long-term gain from harvested timber within the capital gains structure at the present differential to maintain and expand the progress in forestry that has been achieved. In fact, further improvements in the general taxation of capital gains are warranted. First, the corporate capital gains tax rate should be lowered to bring it in line with the individual rate. The current 8 percentage point differential is effectively a penalty which discourages the use of corporations as an investment vehicle. A reduction in the corporate capital gains rate to equal the individual rate would promote equity among all forms of timber ownership and would help assure still greater supplies for wood.

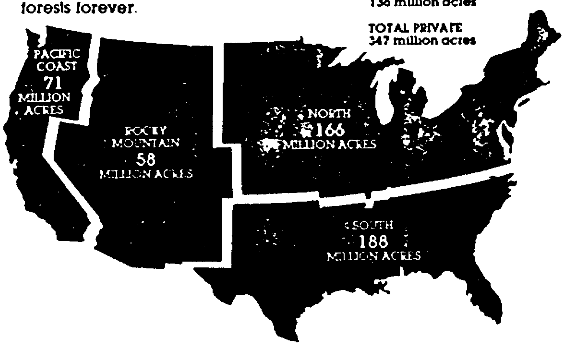
Several times Congress has reviewed the justification for giving capital gains treatment for timber and each time has found it was achieving the objective of better forest management. Until recently the capitalization and deduction rules applied to timber owners have never been challenged in the Congress.

Unfortunately, recent proposals calling for the repeal of timber capital gains, along with new capitalization requirements to be uniquely applied to timber, reveal a shortsighted view of the problem. Obviously, any proposed changes in the tax law should first be carefully analyzed to determine the effects on our domestic and international economic objectives, our human needs, and on our environment.

Eliminating or restricting capital gains treatment and changing other fundamental rules of taxation for timber owners would inevitably produce severe shortages, sharp price rises, dependence on inadequate substitutes and higher imports. It would be a serious blow to our balance of payments, it would be detrimental to the environment, and it would increase unemployment.

The loss of fair taxation of timber could jar the economic well-being not only of companies and individuals but of many communities. It would make forestry in many areas uneconomical and would destroy the vigor of the nation's forests on which we all must depend.

We must look to the future. And we must realize that a tree not planted represents potential timber growth that cannot be recovered. It is within the power of men and women today to assure the continuation of adequate forests forever.



Before the

COMMITTEE ON FINANCE
UNITED STATES SENATE

COMMENTS OF

FLORIDA CITRUS MUTUAL

CONCERNING AGRICULTURAL ASPECTS
OF THE PRESIDENT'S TAX PROPOSALS
TO THE CONGRESS

Bobby F. McKown
Executive Vice President
P.O. Box 89
302 S. Massachusetts Avenue
Lakeland, Florida 33802

BARNES, RICHARDSON & COLBURN
475 Park Avenue South
New York, NY 10006

-and -

1819 H Street, N.W.
Washington, D.C. 20006

James H. Lundquist
Matthew T. McGrath

These comments are filed on behalf of Florida Citrus Mutual, Lakeland, Florida ("FCM"), in connection with the Committee's review of the tax reform proposals now under consideration and specifically with regard to the President's Tax Proposals to the Congress (May 1985) (hereinafter "President's Proposals"). FCM is a voluntary cooperative association of citrus growers and processors, whose grower membership of 13,044 accounts for over 90% of the citrus grown for processing in Florida, and for the bulk of citrus grown for processing throughout the United States, including California, Arizona and Texas.

In general, FCM favors reform of many of the tax structure's unnecessary complexities. However, several provisions in the present law are intended not only to encourage and maintain the productivity of the U.S. citrus industry, but already prevent or discourage some of the unfair advantages, in reality or perception, which the President's proposal seeks to redress. At present, the industry is struggling to recover from an unprecedented four destructive freezes in five years, and must maintain its level of expenditures for replanting and the opening of new groves in order to recover to its position prior to the series of years of inclement weather conditions. The present tax structure affecting agricultural expenditures and property transactions, especially as it relates to citrus groves, encourages this recovery effort while not resulting in a substantial loss of revenue to the U.S. Treasury. However, some proposals for the revision of business and capital income taxes could seriously undermine this recovery and discourage production of processed citrus products to meet U.S. demand.

The following are specific aspects of the President's Proposals of particular concern to FCM's members. Other aspects of the proposal are under review, and FCM would like the opportunity to comment on them when the Committee decides to analyze the tax reform plan for the introduction of legislation:

(1) Treatment of capital expenditures for developing citrus groves - Current provisions of the tax law permit agricultural taxpayers to treat as current expenditures many costs associated with land and soil preparation that would otherwise have to be attributed to capital account, including soil and water conservation expenses, fertilizers and soil enhancers, and land clearing costs. The President's proposal would repeal the treatment of these items as expenses, and would require that they be capitalized. The stated policy for this change is as follows:

> The extensive Federal involvement in agricultural input and output markets makes additional tax-based subsidies unnecessary and inefficient. Outlays to drain marshy soil, create ponds, install irrigation ditches and condition soil all have the objective of yielding greater farm output in the future. Under ordinary accounting principles they should be capitalized or inventoried -- treated as the purchase of an asset -- rather than treated as a cost of the current year's output. If the land-improving investments are rationally made, the farmer has merely exchanged cash for an

> assest of equal value -- improved land -- the expected market value of which will accure to him as output occurs.
>
> President's Proposals, p. 187 (May 1985)

FCM wishes to point out that the Administration's policy concerns have already been addressed with respect to the citrus industry, through amendments enacted in 1969. Under section 278(a) of the Internal Revenue Code, any amount allowable as a current deduction, as described above, which is "attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof) and which is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted, shall be charged to capital account". Pursuant to rulings of the Internal Revenue Service, the amounts expended for land development, clearing, and other pre-planting activities are included in the cost of the land. Later expenditures incurred during the first four years in planting and developing the grove, such as fertilier, spraying and irrigation, are capitalized under section 278 and may be depreciated over the productive life of the trees. Section 278 eliminates any current deductions for these pre-production expenses and, like the President's proposal, requires them to be capitalized, thus discouraging investments in citrus groves for tax shelter purposes alone. The current law treats the expenses associated with the land as "purchase of an asset", and expenses associated with the trees as capital expenditures, as intended by the President's Proposals.

An important exception to the rule on capitalization of development costs for citrus groves, which would be swept away by the new proposal, is included in the present section 278(c), which permits expensing of "amounts allowable as deductions (without regard to this section) attributable to a grove, orchard or vineyard, which was replanted after having been lost or damaged (while in the hands of the taxpayers) by reason of freezing temperatures, disease, pests, or casualty." Thus, the only circumstance in which a citrus grower could now deduct fertilizing, irrigation, and other expenses is during his recovery from a casualty loss such as a freeze, hurricane, or other catastrophic loss. This treatment is extremely important for growers suffering severe weather related losses, as Florida has experienced in December 1983 and January 1985. Citrus growers can expect no income from orange and grapefruit trees for at least four years after planting -- an assumption inherent in the limitation set forth in section 278(a). Thus, the current burden of replanting a freeze-devastated grove can be severe and long-term, <u>especially</u> for the small farmer whose competitive position the President's tax plan seeks to enhance.

In light of the fact that the citrus industry has already adopted the approach set forth by the President for capitalizing land improvement costs which other non-citrus farmers may deduct, FCM believes that the basic intent of the Proposals has been met. However, any broad capitalization requirement which would eliminate the exception for casualty loss expenses should be rejected.

Furthermore, recovery from recent casualty losses in Florida is restricted to a degree by the limitation now included in Section 278(c), that cost of replanting, cultivation or development of a grove suffering a casualty loss may only be treated as deductible expenses if the loss of the grove occured "while in the hands of the taxpayer". In order to facilitate the investment of recovery capital, under certain extreme circumstances, we believe that this phrase should be modified in order to permit the deduction to apply to subchapter S corporations or partnerships, some of whose members may not have held the property when the casualty loss occurred. This would increase the incentive for growers to invest in recovery efforts which a single grower may not be able to fund adequately. Since this section is, by its present terms, an extraordinary measure, FCM proposes that the exception to permit the deduction of casualty loss recovery costs by partnerships and subchapter S corporations be limited to situations in which the loss is of such a wide-spread magnitude that a federal Declaration of Emergency has been issued by the President or the Secretary of Agriculture. Thus, the special expensing treatment would clearly be available to partnerships and small businesses which did not hold the property at the time of the loss, only when there is an extraordinary emergency, rather than simply a limited, geographically confined casualty loss. The treatment of recovery costs as expenses by a grower for normal casualty losses, which are not the subject of an emergency declaration, would then be treated as currently provided for under

Section 278(c), and the deduction would be available only to the taxpayer holding the grove at the time of the loss.

FCM believes these suggested amendments would reaffirm the extraordinary nature of Section 278(c) treatment while encouraging recovery of freeze-devastated citrus business within the basic intent of the President's Proposals.

(2) Treatment of inventoried fruit upon purchase of a grove - Presently, a purchaser of a citrus grove may elect to treat the fruit on the tree as inventory, and liquidate that inventory in order to meet the down payment requirements for sale of the grove. The President's Proposals would eliminate this treatment and, through changes in the applicable accounting methods for agricultural production, require that the purchaser pay tax on the on-tree fruit upon sale of that fruit. FCM believes that this would discourage needed investment in citrus groves for the purposes of recovering from recent weather-related damage.

(3) Capital gains treatment on disposition of depreciable property - Under present tax law, to the extent there is any gain realized on the disposition of property including citrus groves, which are depreciable assets, any prior depreciation taken on such property is recaptured as ordinary income, and the amount realized in excess of the recaptured ordinary income is treated as a capital gain for tax purposes. Under the President's Proposals, all gain

realized on disposition of the citrus grove would be taxable as ordinary income and would not be treated as a capital gain, regardless of the amount of depreciation recapture which is included in the seller's basis in the property. This approach would deter investment in citrus property, since a prospective purchaser who may be interested in renovating damaged groves will not be able to realize any capital gains benefit, even after recapture of depreciation he has taken while holding the grove.

The policy of the President's proposal is that "Business income, whether derived from the sale of property used in a trade or business or from the sale of property to customers in the ordinary course of business, should be taxed as ordinary income. The preferential tax rate on capital gains should apply only to investment assets" President's Proposals, p. 168.

However, this policy does not recognize the need for encouraging significant capital infusion, which is not invested for purposes of sheltering funds from taxes, to regenerate an industry affected by natural setbacks and which, because of it is a perrenial crop, requires several years to achieve commercial production. FCM believes that the proposal would have a detrimental impact on growers who are unable to meet current extraordinary costs, and must sell their property, as well as deterring needed new investment for recovery efforts.

FCM also opposes certain other aspects of the Proposals. The use of the cash method of accounting for tax purposes would no longer be permitted if a farmer has gross annual receipts of more than $5,000,000. The policy behind the change is that "The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business...Obligations to pay and rights to receive payments are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or loss." President's Proposals, p. 213. Again, this policy may reflect accounting realities in certain other industrial enterprises, but not in the citrus sector. Citrus growers are residual beneficiaries of the revenue received for the finished, processed product. Their income is determined after deduction for the costs of processing and packing, and although a price may be set for fruit in advance of its sale under participation plans or on the spot market, the receipt of revenue by the grower in a cooperative, as opposed to those selling on a cash basis, may not occur until several months after delivery of the fruit to the processor. The imposition of accural accounting on all growers, FCM believes, would be unrealistic and would not reflect the economic results of the taxpayer's business over a taxable year; even though a right to payment may have been fixed during a tax year, the amount of that payment and of certain offsetting obligations may not be established until the following tax year. Therefore, it would be unreasonable to limit the use of cash accounting methods to citrus growers with gross annual receipts of less than $5,000,000.

Florida Citrus Mutual appreciates this opportunity to comment on the agricultural aspects of the President's Tax Proposals. Of course, we have addressed here, on an initial basis, only those aspects which FCM believes would be detrimental to the citrus industry and which, as applied to this industry, would not appear to meet the stated policy of the proposal. Some elements of the Plan would undoubtedly institute needed reforms in the overall tax regime. FCM would like the opportunity to submit additional comments and offer testimony at such time as the Committee undertakes consideration of legislation to implement the Plan.

Respectfully submitted,

Bobby F. McKown

FLORIDA CITRUS MUTUAL
Bobby F. McKown
Executive Vice President

Counsel:

Matthew T. McGrath

BARNES, RICHARDSON & COLBURN
1819 H Street, N.W.
Washington, D.C. 20006

James H. Lundquist
Matthew T. McGrath

July 25, 1985

Interfaith Action for Economic Justice

110 Maryland Avenue, NE
Washington, DC 20002-5694
202/543-2800

800/424-7292 (legislative updates)

Statement of Interfaith Action for Economic Justice
on the
Impact of Tax Reform on American Agriculture
before the
Committee on Finance
US Senate

July 10, 1985

<u>Summary of Recommendations on Reagan Tax Proposal</u>

A. Favorable Provisions

1. Elimination of investment tax credit;
2. Limited deductibility of preproduction expenses or allowance of deductions only if added to inventory;
3. Elimination of capital gains treatment of livestock held for dairy, breeding, draft, or sporting purposes.

B. Provisions Needing Modification

1. Elimination of conservation deduction. Modify to eliminate for land clearing, leveling, and draining but continue for terracing and other legitimate conservation efforts if part of an approved conservation plan.

2. Disallowing cash accounting for taxpayers with more than $5 million gross sales. Modify to limit deduction of farm losses from nonfarm income to the national median income minus the amount by which the taxpayer's income exceeds twice the median, and limit deductions for advance purchases of inputs to the national median income or 25 percent of total annual expenses for such inputs, whichever is less.

3. Limiting deduction of nonbusiness interest to $5,000 plus net investment income. Modify to disallow business interest deduction to any nonfarm investors in agriculture no matter what form of business organization is used.

C. Unacceptable Provisions

1. Continuing artificial incentives through accelerated depreciation (CCRS);
2. Continuing capital gains exclusion.
3. Continuing graduated corporate rates.
4. Eliminating income averaging.

On all of these four, we urge adoption of Treasury I proposals or something close to them.

Interfaith Action for Economic Justice is a coalition of national Protestant, Catholic, Jewish, and ecumencial agencies working together for just and effective food and agriculture, health and human services, development, and economic policies. We welcome this opportunity to present our views and recommendations to the Committee.

Interfaith Action speaks for itself and not directly for its member agencies. However, our recommendations are consonant with the public policy recommendations of our sponsoring groups. As an indication of the strong support for agricultural tax reform among religious agencies, I would cite a few recent public policy pronouncements:

> We favor reform of those tax policies affecting agriculture which now encourage the growth of large farms, attract into agriculture investments by nonfarmers seeking tax shelters, and disproportionately benefit large and well-financed farming operations.
>
> —"Food and Agriculture," Chapter Five of the Draft US Catholic Bishops' Pastoral Letter on Catholic Social Teaching and the US Economy, 1985
>
> (We) call upon the US federal, state, and local governments...to restructure investment and tax policies to promote small and moderate-sized family farm operations.
>
> —Agriculture and Rural Life Issues, United Methodist Church, 1984 General Conference
>
> (We) seek to generate support for public policies which will help permit economic survival of small and moderate-sized farm operations and help diminish existing policies which contribute to concentration in farmland control (including) tax policies which reward bigness and farm expansion beyond the level of economic efficiency.
>
> —The Land, American Lutheran Church, 1982 General Convention
>
> We declare our support for public policy that would restructure tax laws...so as to strengthen an agriculture based primarily on small and moderate-sized family farms. This involves eliminating incentives that favor large units, stimulate absentee ownership, or encourage corporate control of resources.
>
> —Interfaith Statement on Public Policy and the Structure of Agriculture, a joint declaration of 17 national religious leaders from 15 denominations and faith groups, 1980.

Our member agencies have a long history of involvement in farm, food, and rural policy. Key aspects of this engagement have been and continue to be support for a widely dispersed family farm system, strong rural communities, responsible resource stewardship, responsive domestic food assistance available to all in need, and a significant US contribution to world food security. Based on these concerns, we support farm and food policies, including tax policies, that would help assure:

—equitable access to and widespread distribution of farmland and productive assets;

—fair returns and legal protections for farmers and farmworkers;

—long term sustainability of all food producing resources;

—healthy rural communities and broadbased rural development;

—adequate, stable supplies of safe and wholesome food;

—access to adequate food and nutritious diets by all segments of the population; and

—equitable agricultural development and food security in other countries.

New Momentum for Tax Reform in Agriculture

This past December, a group of individuals from a wide variety of farm, food, rural, conservation, and church organizations issued a report titled Beyond Crisis: Farm and Food Policy for Tomorrow. Participants in the coalition came from such organizations as the National Grange, National Farmers Union, National Farmers Organization, Rural Coalition, Center for Rural Affairs, American Farmland Trust, Environmental Policy Institute, Bread for the World, and Interfaith Action for Economic Justice. One of the major planks in the statement was on tax policy. I would like to read part of this statement because of its importance as perhaps the first such declaration by such a varied coalition.

"Federal tax policy is one of the most important, but least understood, government forces shaping the structure of agriculture. Farming offers substantial tax shelters-investments which generate lower tax burdens or greater tax savings than alternative investments of equal profitability. Tax shelters affect investment decisions by farmers, non-farm investors, and corporations, attracting investment to farmland purchases and crop and livestock production. The resulting increased production lowers crop and livestock prices.

"Moreover, the tax benefits of investing in land are bid into its price, raising costs and creating losses for farmers trying to pay for the land by actually farming it. Thus, when farm profits fall and land prices weaken, farmers and speculators reduce tax motivated investments, creating more severe price declines...These distortions in the land market, combined with lower crop and livestock prices, result in a net loss for moderate sized and beginning farmers...

"In general, tax shelters grant a comparative advantage to farmers with high incomes, non-farm investors and corporations, and larger farms...Small, moderate-sized, and beginning farmers benefit little from growth and labor-replacing incentives."

Among the recommendations of this coalition are the following:

—eliminate or strictly limit cash accounting, the investment tax credit, and deductibility of capital investments;

—change depreciation schedules for capital assets used in farming to approximate actual decline in value over the useful life of each asset;

—tax capital gains more severely;

—limit deduction of interest as a farm expense to farmers active in the daily operation of their farms;

—tax all farmers according to the same tax schedule by taxing corporations as partnerships or by some similar method; and

—limit deductions of farm losses from nonfarm income.

Tax Policy as Agricultural Policy

In 1977 and again in 1981, Congress declared it to be US policy to "foster and encourage the family farm system of agriculture." Congress further stated that "it is the policy and the express intent of Congress that no such (agricultural or agriculture-related) program be administered in a manner that will place the family farm operation at an unfair economic disadvantage." In the 1981 version of this legislation, Congress, at the urging of Interfaith Action, specifically required the Executive Branch to report on the effects of tax policy on the family farm system.

Reports from USDA and the Council of Economic Advisors have clearly established that current tax policy flies in the face of the stated intent of Congress. These reports have confirmed our belief that unless tax laws are changed significantly, there is little hope of maintaining a family farm system of agriculture.

In 1983, USDA reported that the organization of farms is influenced by five primary effects of tax-sheltering possibilities...The tax-sheltering possibilities generally:

—make current cash income and expenditures a downward-biased indicator of the economic returns in agriculture;

—inflate asset values by their expected return as possible tax shelters, further depressing the apparent rates of return based on cash income and expenditures;

—stimulate more investment in farm assets than would otherwise be warranted, thus depressing commercial returns by stimulating greater production of farm products, which, in turn, lowers their prices;

—foster ownership of farm assets with tax-sheltering possibilites by those who can best reap the benefits of the tax treatment of these assets;

—create very high barriers to entry of new owner-operator farmers, unless farmland is gained through inheritance or subsidization of the farm business from off-farm income or wealth sources.

A new USDA study issued just last month concludes that 20 percent of the net investment in agricultural equipment from 1956 to 1978 (prior to the big increase in investment incentives) can be attributed to tax policy. To the extent that this tax-based investment increases production, "tax policy and farm commodity programs are contradictory," the report concludes.

Finally, we would call your attention to the following statement in the 1984 Economic Report of the President:

> Tax policy does not affect the profitability of all types of farms equally. The tax laws encourage the substitution of capital for labor. Larger farms, which generate higher incomes, appear to gain proportionately greater benefits than small farms. People in higher marginal tax brackets can benefit more from the tax provisions. This creates an incentive for higher-income people to invest in farming. In practice, losses from farm operations reduce taxes on other income by more than the total Federal tax revenue from farm profits, implying that total farm income for tax purposes is negative. (emphasis ours)

In summary, tax policy works directly against many of the major purposes of agricultural policy:

—It lowers commodity prices, which farm programs are designed to support.

—It fosters overproduction, which farm programs are designed to control.

—It subsidizes investments in bad soil and water conservation practices, which then increase the costs of conservation programs.

—It encourages the carrying of higher debt loads, which contributes to credit crises and the need for debt relief when the farm economy is bad.

—It drains the federal coffers of substantial revenue at a time when Congress is hard pressed to find budget savings in the agricultural function.

—Most important, it fosters the demise of the family farm system of agriculture.

The President's Tax Proposal

The basic premise of the movement toward comprehensive tax reform—creating a broad-based income tax—is to be applauded. In this regard, the Treasury plan released last November was a milestone. That plan went a long way toward eliminating artificial incentives and tax sheltering possibilities in agriculture.

The plan presented by President Reagan in May, while retaining some important positive features, is nonetheless a substantial retreat from comprehensive reform. His proposal would keep farm tax shelters alive and growing, continuing a very inequitable and inefficient means of delivering subsidies to agriculture.

However, the President's plan does contain major improvements over current law. These include elimination of the investment tax credit, limits on deductibility of preproduction expenses, elimination of capital gains treatment for breeding stock and dairy cows, and elimination of deductions for land clearing, leveling, and draining.

These benefits of the plan are overshadowed by tax breaks that would be maintained or extended. Chief among these are accelerated depreciation, the exclusion for capital gains, graduated corporate rates, cash accounting, and business interest deductions.

The proposed individual rate structure should be beneficial to the majority of farmers. However, the loss of income averaging would hurt, especially in a business as inherently unstable with regard to income as agriculture. Also, the reduction in the top rate, coming on top of a large reduction in 1981, is too great. High income farmers and investors would be favored with the largest tax cuts in relation to income and would thus be granted yet another tax-related advantage. The savings, moreover, could be turned to bidding away resources from family-sized farms.

Finally, careful attention must be paid to revenue effects. The most needed "farm income program" right now is a deficit reduction that leads to a decline in interest rates and an decrease in the overvalued dollar. If such an approach were taken, tax reform would need to raise enough revenue to make a significant contribution to deficit reduction. In any event, the Treasury-projected $15 billion a year revenue losses would seem to defeat even the goal of revenue neutrality.

Specific Provisions: Special Farm Rules

1. Preproduction Expenses. We support the President's proposal. The costs of raising fruit and nut trees and vines and breeding or dairy livestock to their productive stages would be capitalized and depreciated rather than deducted currently. This change would effectively remove from the code a significant farm tax shelter.

As the Congressional Research Service observes, "Under existing law, the present value of the tax savings from deducting preproduction expenses plus the present value of future after-tax income from the asset is typically greater than the present value of future pre-tax income; in other words, the investment is more profitable after taxes than it was before taxes (at least, for those who have sufficient tax liability on other income to use the deductions)...The Treasury's proposal institutes a more neutral tax treatment, which in this case means higher taxes...More nearly equal tax rates could be beneficial to the farm economy if they discourage tax shelter operators." ("Effect of the Treasury Tax Reform Proposal on Farm Income Taxation," January 30, 1985, p. 16,17)

2. Capital Gains Treatment of Livestock. We support the President's proposal. Gains from the sale of livestock held for dairy, breeding, draft, or sporting purposes would be treated as ordinary income. Under current law, they are afforded the substantial tax preference of treatment as capital gains even though they are held as business property. According to the May 29 statement of Agriculture Secretary Block, the proposal "will tend to raise the tax burden on livestock farmers, but other provisions in the tax reform proposal could more than offset the loss of this preferential tax treatment." (p. 3) In return, incentives for overproduction will be lowered and thus prices should improve.

3. Cash Accounting. We urge that more strict limitations be added to the proposal. The plan would do very little to restrict the cash accounting privilege that enables farmers and investors to mismatch expenses and income, create artificial losses, and defer taxation. Under the plan, cash accounting would not be allowed for syndicates and taxpayers with more than $5 million gross sales. This part of the plan needs improvement. At a minimum, the cap should be dramatically lowered. More importantly, the deduction of farm losses from nonfarm income should either be limited to the national median income and disallowed for anyone with nonfarm income substantially greater than that, or be disallowed altogether for anyone using cash accounting. Consideration should also be given to limiting deductions for advance purchases of inputs to 25 percent of total annual expenses for such inputs or national median income, whichever is less.

4. Deductions for Land Clearing, Leveling, and Draining. We support the President's proposal, with some modifications. Under the

proposal, deductions for expenses related to converting woodlands, rangelands, and wetlands to crop production would be eliminated. This provision should be supported because it removes incentives for farming marginal lands. It would also make tax policy more consistent with the current bipartisan effort to remove commodity program benefits for producers who break out marginal land. One note of caution is in order, however. The proposal would also eliminate the deductibility of expenses related to legitimate conservation efforts such as terracing and windbreaks. This policy might be acceptable as long as conservation cost share and credit programs receive adequate funding. If current budget cut proposals are enacted, however, little or no support would exist for conservation efforts. Rather than eliminate the deduction, the Committee could redefine legitimate conservation expenses and require the taxpayer to have a Soil Conservation Service-approved farm conservation plan before taking deductions.

Specific Provisions: General Rules

1. Investment Tax Credit. We support the proposed elimination of the investment tax credit. As the proposal notes, "the investment tax credit is a standard element of numerous tax shelter offerings that depend upon up-front deductions and credits for their viability." (p. 161) The proposed elimination would help curb the dramatic growth of new large-scale dairy and hog facilities, which have increased production, decreased prices, and created artificial competition to the detriment of the family farm. Moreover, the proposed continuation of the option of expensing up to $5,000 a year should provide adequate assistance for necessary equipment purchases.

2. Depreciation. We oppose the adoption of CCRS as well as the continuation of ACRS. The revival of accelerated depreciation in the proposal is the single biggest setback to the tax reform proposed in Treasury I. We firmly believe that depreciation should approximate actual declines in value over real useful lives of assets. As Treasury itself stated, "(current) capital cost recovery provisions

hamper economic efficiency. The tax code effectively guides the allocation of capital, overriding private market factors...This undeclared government industrial policy (and, we would add, agricultural policy) has grown dramatically in scale and yet it largely escapes public scrutiny or systematic review." (p. 157)

By combining accerated depreciation and indexing, as is now proposed, artificial incentives are actually increased, as the plan admits: "At an assumed inflation rate of five percent and an assumed real discount rate of four percent, the incentive depreciation rates under CCRS produce greater present value depreciation benefits than does ACRS without the investment tax credit. At higher assumed inflation rates, the CCRS incentives are even greater relative to ACRS." (p. 149) The revenue loss compared to Treasury I is a staggering $175 billion over the first five years.

3. Capital Gains. We oppose the continuation of the capital gains exclusion. The exclusion is a major force in creating tax shelters; it should be replaced by Treasury I's proposal to index gains and then tax them as ordinary income. Indexing would be a better deal for most family farmers, who would usually hold their assets for a long time, whereas the exclusion is a boon to speculative investors.

4. Business Interest Deductions. We urge that the proposal be strengthened to disallow business interest deductions for any nonfarm investors in agriculture, no matter what form of business organization is used. The proposal would limit deductions of nonbusiness interest, interest incurred as a limited partner, and interest incurred as a stockholder in a Subchapter S corporation in which the stockholder is not involved in management to $5,000 plus net investment income. This provision would not prevent nonfarm investors from deducting interest in most instances, despite its intent. In order to claim interest as a business expense, the taxpayer should have to be active in the day-to-day labor and management of the farm. A definition of nonfarm investor should be tightly drawn and added to the proposal to achieve this purpose.

5. Graduated Corporate Rates. We oppose the continuation of graduated corporate rates. In place of Treasury I's single corporate tax rate, the President's plan would retain a graduated structure for income under $75,000. Under this provision, the income tax rate for corporations would be lower than the rate for individuals reporting the same income whenever taxable income is above $29,000. This lower rate is a strong incentive for families to incorporate larger farms and, once incorporated, to keep expanding, because there is less tax due if profits are left in the corporation. This provision allows larger farmers with high incomes to keep their tax rates as low as smaller farmers with much less income. It should be removed in favor of a single corporate rate.

6. Income Averaging. We oppose the total elimination of income averaging. It is particularly unfair that one of the tradeoffs for the revenue losing tax shelter provisions put back in the proposal is the elimination of income averaging. Whereas Treasury I would have tightened the rules concerning students who use income averaging, the President's proposal eliminates averaging altogether. This does not erase the fact that individuals whose income varies widely year to year pay more tax than individuals who earn comparable amounts evenly over the same period. Averaging is particularly important to many farmers whose incomes do swing up and down.

Conclusion

Virtually all farmers are conscious of these and related income tax rules and to some degree make their management decisions mindful of the effect on their after-tax income. With the exception of the very smallest farms, net farm income is taxed less severely than equivalent income from nonfarm sources. Moreover, this spread between taxes on farm and nonfarm income widens as income increases.

Individually, farmers have little choice but to take advantage of any tax breaks for which they qualify if they wish to survive as farmers. But collectively, their decisions lead to results that only a few would advocate--fewer,larger farms, inflated and unstable values for farm assets, overproduction of tax-favored commodities, lower commodity prices, inefficient use of resources, and the deterioration of rural communities.

Without substantial reform of individual and corporate income tax rules, inequity and inefficiency will continue to grow while the family farm system will continue to die. Real tax reform is essential if Congress is serious about its oft-stated commitment to the family farm system of agriculture. We encourage the Committee to set upon this task with all urgency, improving upon the President's proposal in some of the ways noted in this statement.

UNITED STATES SENATE COMMITTEE ON FINANCE
HEARINGS ON TAX REFORM
JULY 10, 1985

Statement by Johnnie McLeod, President
Jasper-Newton Counties (Texas) Forest Landowners Association

My name is Johnnie McLeod and I am speaking on behalf of the Jasper-Newton (Texas) Forest Landowners Association -- a group of private, non-industrial owners of timber-growing land in a two-county area of Deep East Texas. Our timber is mostly Southern pine species that are produced for pulpwood, poles, plywood and dimension lumber.

The acreage owned by our members averages out at less than 250 acres per member. We are business or professonal people who acquired land as a long term investment or from family interests; most of us are retired. Few, if any, of us consider our investments in timber growing as tax shelters. (I myself am a retired county school superintendent. I began buying my acreage in 1957 as an investment. After many years of hard work and substantial investment, I was named Tree Farmer of the South in 1982.)

I am making this statement because our membership is deeply concerned about the effects of those provisions of the proposed tax reform which would (1) repeal the capital gains treatment of income derived from sales of timber for pulpwood, lumber or other uses and (2) require the capitalization of forest management expenses. These proposals show a complete ignorance of what's involved in growing timber.

Permit me to make four simple points.

1. <u>The Income from Harvesting Timber is NOT Like Other Capital Gains</u>

The income from harvesting trees is <u>not</u> a simple windfall profit to be taxed accordingly. Rather it is the result of diligent forest management applied over a period ranging from twenty to forty years. Of course, pine trees do grow naturally, but their value as timber is greatly increased by scientific planting, proper cultivation and careful harvesting.

While this effort is being carried out, the tree farmer is threatened from time to time by beetle infestations and forest fires. Furthermore, he never can be assured of the price he will eventually receive for his trees since the pulpwood and sawlog market is fluctuates considerably in both the short and long term.

Think of a businessman waiting twenty or forty years for a "pay-day" and then have it treated as ordinary income in the year he gets it. The income from timber sales should not be confused with profits from the sale of property or other transactions that are normally considered capital gains.

2. <u>The Proposal Would Kill Incentive for Responsible Forest Management</u>

Early in this century the common practice was to buy a tract of timber, cut it, sell it and walk away from it and find another timbered tract. As a result, fifty years ago this area had virtually depleted its natural forest resource. Then enlightened, responsible forest management practices began to take hold. Private, non-industrial tree farms -- like ours -- began to appear. Our efforts were encouraged and aided by Federal, state and private programs to stimulate reforestation and cultivation. Now, the forests are again this area's main resource.

We are told that the private, non-industrial tree farmer is essential to the maintenance and expansion of this nation's resource base. We can assure you that if the capital gains treatment is repealed by this so-called tax reform, private forest landowners will again "walk away" from their commitment to responsible forest management because there would be no incentive to do otherwise.

3. The Proposal to Capitalize Expenses Contradicts Reality

As timber growers, we can now deduct forest management expenses, property taxes and interest payments in the year they are incurred -- just like other taxpayers. The Administration's proposal would require tree farmers to capitalize these expenses and deduct them from the income received when the trees are harvested. The fact is -- and I repeat it -- a tree cannot be harvested for pulpwood until it is about 20 years old or for lumber until it is 35 years old.

No prudent person would expend funds with no prospect for return for 20 years or more without some tax consideration. If this proposal is enacted, private, non-industrial timber growers would simply bow out of the picture.

4. The Proposal Leaves the Established Tree Farmer Holding the Bag

Many of our members have been investing time and money in tree farms for years. We made the effort because we expected that the income from the infrequent sales of timber to be treated as a capital gain. Now we are faced with the prospect that those rules will no longer apply. This leaves us holding the bag ... for someone else probably. That would be unfair.

* * * * *

We, the members of the Jasper-Newton Counties Forest Landowners Association urge you to reject the proposals to repeal the capital gains treatment of timber income and to capitalize expenses. There is an urgent need to correct the awful deficit situation confronting this nation, but this "tax reform" does not address this issue. Public opinion polls indicate that most people do not think the "tax reform" is equitable, and we would certainly agree.

Respectfully submitted,

Johnnie McLeod

Johnnie McLeod

T. J. La Brucherie
P. O. Box 1420
El Centro, Ca. 92244

July 15, 1985

Betty Scott-Boom, Committee on Finance
Room SD-219, Dirksen Senate Office Bldg.
Washington, D. C. 20510

In Re: July 10, 1985 hearing on agriculture.

Dear Ms. Scott-Boom:

Unfortunately, I was unable to address your Committee during the July 10 hearing concerning the impact of Treasury II on agriculture. Therefore, I am submitting this letter to express my grave concern about the adverse impact that Chapter 8.03 of Treasury II would have on the agricultural industry.

Chapter 8.03 would put all farms with gross income of $5,000,000 or more per annum on the accrual method of accounting and the analysis to Chapter 8.03 states that the number of farmers to be affected by this legislation would be no more than 300.

This is simply not true. There are thousands of farmers in the United States that grow capital intensive crops such as fruits and vegetables in which very few acres can easily produce a gross revenue of $5,000,000 per annum. Take lettuce grown in the Salinas Valley of California, for example. With a breakeven $5.00 a carton selling price, one would have gross sales of $5,000,000 in one year with just 550 acres of double cropped lettuce.

This legislation would force many more than just a handful of farmers into the accrual method of accounting. In California alone it is my estimate that as many as one-half of the vegetable farmers might be affected by the legislation.

I was a Certified Public Accountant in the agricultural intensive Imperial Valley of California before joining the family farming business with my father. After working in public accounting with many farm accounts, I can easily see what a devastating impact a conversion to the accrual method of accounting would have on my former agricultural clients.

Farming is not at all like the common small business that provides goods or services in which net income does not generally fluctuate substantially from year to year. Because of the instability of farm commodity prices, expecially in the fresh produce industry, coupled with unpredictable weather, disease and insect problems, it is common for farmers to have very wide fluctuations in annual net operating results.

I have pieced together, as best I can from memory, three years of one of my former farm clients financial records to give you an example of what would have happened to him had he been on the proposed accrual method of accounting instead of the cash method. His average gross sales were about $6,000,000 a year for the three years in my example.

SCHEDULE F NET FARM INCOME (LOSS) BEFORE TAX

Rounded to the nearest thousand

	Year 1	Year 2	Year 3	Total
Actual Cash Method	38,000	3,000	1,000	42,000
Proposed Accrual Method	303,000	(218,000)	(43,000)	42,000

The reason the accrual income is so much larger than the cash income in year 1 is that the crops were harvested near the end of year 1 so that most of the sales proceeds were not received until year 2, (income is not recognized on the cash basis until received) when the second year crops started losing money.

The fate of this farmer is self evident had he been using the accrual method of accounting. After his first successful year he would have paid out about one-half of his profits in State and Federal income tax leaving him critically short of working capital needed during year 2 to absorb the crippling losses. Since he would not have been able to get a net operating loss refund from the government until well into his third year when filing his second year tax return, the refund would have come much too late to satisfy his creditors who would have shut off his credit and forced him into bankruptsy months before. The cash basis, in contrast, gave him the financial leverage needed to sustain his farm through the two lean years that are so common in the agricultural industry.

The accrual method of accounting would be difficult to apply in my farming operation for still another reason. We grow several crops such as cotton, cannery tomatoes, and sugar beets for which the final sales price is not determined for more than a year after harvest. Our tomato contract with Hunt-Wesson calls for an initial payment of $30.00 per ton and a final payment of up to another $25.00 per ton, determined by a formula based on the average wholesale price of canned tomatoes sold during the following year. Trying to apply the accrual method of accounting to this type of crop is virtually impossible. At the end of the tomato harvest we don't know whether we have a $200 an acre profit or a $500 an acre loss and won't know for another thirteen months.

If the intent of Chapter 8.03 is to put big publicly held corporate farms on the accrual basis, then this need was satisfied in 1975 when Congress enacted Sec. 447 of the I.R.C. Sec. 447 provides that all farming corporations, which are not family owned, with gross sales of $1,000,000 or more, such as Castle & Cook, must be on the accrual basis of accounting.

If the intent of Chapter 8.03 is to put any truly large, heavily capitalized farm, whether family owned or not, on the accrual basis of accounting such as a 50,000 acre multi state farm, then this need could be satisfied by raising the gross sales threshhold to a larger amount such as $25 to $100 million.

But what purpose is served by putting smaller family farms such as the Salinas Valley farmer with the 550 acres of lettuce on the accrual basis of accounting? Farmers are in the worst economic slump since The Great Depression and to compound their plight with a tax law that robs them of up to one-half their working capital during an occasional profitable year, leaving them so helplessly under capitalized that they cannot survive a lean year only helps to accelerate the large numbers of farm bankruptsies that are already overburdening our private banks, the Federal Farm Credit system and the Farmers Home Administration.

Sincerely,

T. J. La Brucherie

TJL/gs

STATEMENT TO SENATE FINANCE COMMITTEE

BY MEDFORD CORPORATION

REGARDING THE

TAX TREATMENT OF THE TIMBER GROWING ENTERPRISE

IN THE

ADMINISTRATION TAX REFORM PROPOSAL

Mr. Chairman and Members of the Committee:

My name is Lynn Newbry. I am a Vice President of Medford Corporation and am presenting this paper on behalf of our Company.

Medford Corporation is an integrated forest products company employing 1,500 people in the manufacture of lumber, plywood, medium density fiberboard, kitchen cabinets and low-pressure laminates. In addition to the manufacturing activities, the Company owns and intensively manages 90 thousand acres of timberland located in Jackson County, Oregon.

We are shocked, and frankly dismayed, at the "Treasury II" proposal for the treatment of income from our silvicultural activities. It indicates a complete misunderstanding of the business of growing and harvesting forest products and casts serious doubt about the understanding of generally accepted accounting practices.

Silviculture (the business of growing trees) is not a great deal different than the growing of perennial crops in agriculture, except for the length of the growing cycle. In both cases, the crop must be planted, protected from insects and fire, properly thinned, fertilized and ultimately harvested.

No one questions the deductibility of costs associated with farming activities from the price of the product to determine the profitability for tax purposes. We can only question why companies and individuals engaged in the growing of forest crops are to be excluded from utilizing those generally accepted accounting practices if the return from the sale of timber at harvest time is to be treated as ordinary income.

Because of the long growing cycle in our area (from 60-120 years depending upon site), the prudence of investing in this crop as an ordinary income activity is questionable. It simply boils down to this . . . if the tax treatment for this kind of investment does not recognize the nature of the business and is not favorable, monies now devoted to timber management will go to other activities where a greater return can be achieved.

This would be an extremely short-sighted public policy and can only result in a much lower rate of growth in timber which, in turn, translates into much longer growing cycle and much less wood fiber for future harvests. The impact of this prospect should be fully investigated by the Committee.

Finally, we wonder why the growing of wood fiber has been singled out for unusual and extraordinary treatment. As we understand the proposal, such expenses as the ad valorem taxes on the land, fire protection and maintenance of the assets could not be deducted from income. Even the wildest speculator in real estate is permitted to deduct these costs as legitimate expenses. Furthermore, if he holds the investment for a mere six months, his income is treated as a capital gain.

Mr. Chairman, we in the business of growing wood fiber simply request that we be treated at least as well as other investors and that the long-term impacts of the Administration's proposal be carefully evaluated.

Testimony of the
Multi-Housing Laundry Association
Senate Finance Committee

July 10, 1985

The Multi-housing Laundry Association thanks the Committee for the opportunity to present testimony concerning the impact of the President's tax reform proposals on small business. Please add this testimony to the record of the hearing held on July 10, 1985.

Before discussing our specific concerns over the President's proposals, we would like to acquaint the committee with the multi-housing laundry industry. This industry provides the nation with professionally designed and operated coin laundry facilities in all types of multi-family housing -- including military housing, federally-subsidized housing, and housing financed entirely by the private sector. We operate laundry rooms in apartments, cooperatives, and condominiums. MLA members purchase and install the laundry equipment, collect the coins deposited in the machines, service the machines, and are wholly responsible for the efficient operation of the laundry room. In exchange for the right to operate a laundry room in a multi-family residence, we provide the owner with a substantial portion of the income received.

The great majority of MLA members are quintessential small businessmen. Almost 90 percent of us have fewer than 50 employees. In running our businesses, we face the problems of inflation, urban crime and vandalism, and high financing costs. We are a highly competitive industry, and strive to furnish the best possible service at the lowest possible cost.

We applaud President Reagan's efforts to reform our tax system, which is certainly in need of an overhaul. We also support many of the President's specific proposals. Alleviation of the double tax burden on corporate income, limitation of unjustified business tax deductions, and changes designed to ensure that the largest corporation pay their fair share are worthy of small business support.

However, we have two major areas of concern. One is the effect that the tax proposals, if adopted as they currently stand, would have on the production of housing in this country. The other is the effect that the proposal to eliminate the investment tax credit would have on our members' ability to prosper and grow.

It is generally acknowledged that the President's proposals would be very damaging to the housing industry, particularly the rental housing industry. The primary reasons for this are as follows:

1. The new Capital Cost Recovery System proposed by President Reagan would greatly increase the depreciation period for real property and would lower depreciation rates. This would lower the flow of capital to real estate, reduce property values, and lead to higher rents.

2. The proposal would repeal capital gains treatment on sale of depreciable property, including real estate. This would discourage investment in real estate and thus reduce housing production.

3. The proposal would eliminate tax-exempt industrial development bonds and mortgage revenue bonds as financing mechanisms for multifamily housing. Half of all multifamily rental housing is financed through tax free bonds, so the effect of this proposal would be devastating.

4. The proposal would eliminate several tax incentives that encourage housing rehabilitation. This will accelerate deterioration of the housing stock.

Even the Administration acknowledges that its proposals will result in higher taxes on real estate than on other assets, which will discourage investment in real estate. According to the Administration's own figures, the tax rate on real estate would be 24 percent, as opposed to 17 to 18 percent on most other assets.

We, of course, are small businessmen whose businesses are inseparably tied to the housing industry. So our personal interests are involved. But more broadly, we are very concerned about the President's proposals as Americans. This country is already in the midst of a rental housing shortage. The problem is rapidly spreading from low- to middle-income Americans, and will be accelerated by the fact that the baby boomers of the 1950's are now creating a baby boom of their own. Many of these new families will be forced to rely on rental housing because increased housing prices have put the "American dream" of a single family home out of reach of many Americans.

Thus, more affordable housing, not less, is greatly needed -- particularly for families. Yet, the President's proposal would do much to retard construction and preservation of such housing. We urge the Committee to take a strong stand against changes in the tax system tha; will make it impossible for Americans to afford decent housing. Although a few of the President's proposals in the housing area merit consideration, for example, elimination of some real estate "tax shelters," the majority should be rejected.

We would also like to call the Committee's attention to a proposal that, aside from the housing issues, would seriously affect the ability of our members and all small businesses to prosper and grow. This is the proposed elimination of the investment tax credit (ITC).

In order for small multi-housing laundry companies to grow, they <u>must</u> be able to purchase laundry equipment. This requires a substantial capital outlay. The ITC has enabled us to purchase the equipment we need to expand. When we are able to expand, we can create more jobs. Elimination of the ITC would put an end to expansion for many of us. In fact, it would even make it difficult for the smaller companies to hold the line, because laundry equipment generally wears out after five years and must be replaced. I am certain that other small businesses whose ability to prosper and expand depends on their ability to purchase equipment would join with MLA in opposing elimination of the ITC. And, support for the ITC is not limited to older industries -- the new high technology companies support it as well.

Congress has repealed the ITC twice in the past. Both times it reinstated the credit shortly after repealing it due to the negative impact of repeal on employment and on the amount of equipment and machinery placed in service. We should learn from the past and leave the ITC intact.

Testimony of Theron Stone, President
National Christmas Tree Association
Before the Senate Finance Committee
U. S. Senate
July 23, 1985

Mr. Chairman and Members of the Committee:

Our use of forests and forest products predates all historical records. Man's utilization of the forest through discovery and education has become the science of forestry, and we now understand how to utilize the forests of the earth without damaging or decreasing their future ability to serve mankind.

The intensive use of forestry has enabled us to produce forest products in much the same method as agricultural crops. The use of intensive forestry has enormously increased the productivity of our forest land. However, it requires the expenditure of substantial time, effort and money to achieve the gains offered by the practice of intensive forestry. The Christmas tree industry finds itself at the forefront of the intensive forestry effort. Government policies, whether intentional or accidental have a profound effect upon the practice of forestry because of the length of time which is required for a tree to become mature and capable of serving the purpose for which it has been nurtured. It is the position of the National Christmas Tree Association that the proposals of Treasury II, whether intentionally or accidentally, represent a severe threat to the practice of all intensive forestry.

Treasury II affects the Christmas tree industry in two primary areas. First, the proposals of Treasury II eliminate sustained yield of timber as being eligible for capital gains treatment and, secondly, it requires the capitalization of all maintenance expenses spent upon a tree until that tree is harvested.

Prior to 1954 the United States imported 90% of the Christmas trees used in this country. In 1954 Congress added Christmas trees to Section 631 of the Internal Revenue Code extending to Christmas tree growers the right to capital gains tax treatment in accounting for the sale of their long term crops. The tax policy of 1954 worked, and the United States now produces between 80% and 90% of the trees consumed in this country and, prior to the enormous change in the value of the peso, the United States was a net exporter of Christmas trees. The industry, at wholesale, now accounts for approximately a three hundred million dollar addition to our nation's gross national product. The total value of the Christmas tree industry is near one billion dollars. It is the position of the Christmas tree industry that the suggested tax changes will probably mean the end of the vast majority of that amount, and this country will become the consumer of yet another import product which could have been produced at home.

The Christmas tree industry is entirely a family oriented enterprise. There is not a single publicly traded company involved in the production of Christmas trees.

The vast majority of Christmas trees produced have spent eight years in the field in addition to two years in a seed bed prior to their marketing. This average ten year age of our product puts our industry in the category with those industries that must invest their capital for many years prior to seeing any return and, in most cases, must pay interest on a portion of that capital which has been borrowed. Under the present rules, the-tax laws allow the expensing of the cost of maintaining the trees and expensing the cost of borrowed capital. The proposals provide for the capitalization of this expense. The result of this new tax policy would be to end all intensively managed forestry, including Christmas trees.

Intensely managed forestry operates at a much higher cost per acre than forest land simply left to regenerate at its own speed and on its own time. Under the proposed treasury bill, seedling nurseries would become an expensive luxury and seed orchards and forest research would be beyond the financial reach of everyone. The private land owner could not afford to protect himself from damaging insects or disease. In short, the treasury proposal represents a devastatingly under thought proposal when applied to multi-year high maintenance cost crops.

A typical tree farm might gross $100,000.00 on the sale of 10,000 trees with an average age of ten years. Operating expenses for the year not attributed to the trees harvested would be approximately $60,000.00 and operating expenses related to the harvested trees at about $15,000.00 resulting in a $25,000.00 gross profit. If the treasury proposals for capitalizing maintenance costs were adopted, the grower would have to report a $85,000.00 profit although he made only $25,000.00 even if treated as capital gains. If treated as ordinary income, the grower faced with an $85,000.00 unmade profit and only $25,000.00 out of which to pay federal tax as well as state income taxes might well find himself in a position of being in a 100% tax bracket.

Even taxed as a capital gain, he would find himself in brackets that approached 60% of his real income while other people, with shorter term passive investments, would pay much less. Even if phased in gradually over a ten year period, the cost of capitalizing expense would be prohibitive to the Christmas tree grower. In the example given, a typical grower in Michigan would be required to report over 320 thousand dollars of income, which he did not receive, over a ten year period. Obviously, the report of unearned income would put the grower in the highest proposed tax bracket. Our industry estimates that, in this example, the grower would go bankrupt in his fourth year. Capitalization of expenses and reporting theoretical profits will also decrease the amount of cash available for Christmas tree farmers to meet their mortgage payments, and many farmers might find themselves in the position of having to go out of the Christmas tree business in order to hold on to their land.

The required capitalization of maintenance expense fails a simple test of logic. A farmer, with an unused pasture, could expense the cost of mowing his pasture incurred to prevent the spread of noxious weeds. However, if the field was planted in Christmas trees, he would be required to capitalize his expense and wait for years to take credit for his control of the same weeds.

The present value of the dollar puts the American Christmas tree grower at a distinct disadvantage with his Canadian competitor while eliminating almost all of the Mexican market. Changes in the American tax law without corresponding changes for the Canadian competitors will, of course, put our Northern neighbors at a competitive advantage.

It should also be noted that much of the production of Christmas trees occurs in areas which are otherwise economically depressed. It is estimated that the Christmas tree industry provides 30,000 summertime jobs for young people and a total employment during the year of 100,000 people. The affect of putting the Christmas tree grower at an economic disadvantage would not only surrender our industry to Canada but would make hundreds of thousands of acres of additional farm land available for overproduction of other agricultural crops which, unlike Christmas trees, are entitled to federal subsidies.

It should be pointed out that the costs required to maintain a Christmas tree during its production period was set by a combination of the costs of labor, the cost of land taxes, interest rates, the costs of pesticides, and the costs of supervision. These costs tend to be set not be conditions within the Christmas tree industry but by conditions outside of our industry. Conversely, when the product is marketed, its value depends strictly upon supply and demand, and the Christmas tree grower has no guarantee that he will even recupe his expenses, much less make a profit.

In addition to the other problems which the Christmas tree grower would face under the present proposal, the grower would be faced with substantial changes in his record keeping system and substantial increases in his accounting costs. The records would have to be maintained on what expense is made at what time on each tree. These record keeping problems would be compounded by partial harvests since most Christmas tree fields are harvested over an extended period of time. Additionally, expenses such as fire prevention on adjoining land, would create an accounting nightmare.

It is the position of the Christmas tree industry that the proposals presently before Congress will be unbelievably damaging to the timber industry and will place such hardship on the Christmas tree industry and other high expense intensive forestry enterprises that they will be driven from the country creating unemployment in the United States, increased imports, and further loss in our balance of trade.

The proposals of Treasury II cannot be considered revenue neutral, because Christmas tree growers now pay taxes, and under the proposed rules, there will not be any Christmas tree growers.

10 year performance of a 120 acre Christmas tree farm during the period implementing the capitalization of the maintenance expense of timber.

Year	Maintenance Percentage Capitalized	Gross Sales	Current Cost of Harvested Trees	Maintenance Cost of Trees Still In Ground	Real (Recognized) Profit	Treasury II Reported Profit	Proposed Tax
1	10%	100,000	15,000	60,000	25,000	31,000	4,500
2	20%	100,000	15,000	60,000	25,000	37,000	6,000
3	30%	100,000	15,000	60,000	25,000	43,000	7,500
4	40%	100,000	15,000	60,000	25,000	49,000	9,000
5	50%	100,000	15,000	60,000	25,000	55,000	10,500
6	60%	100,000	15,000	60,000	25,000	61,000	12,000
7	70%	100,000	15,000	60,000	25,000	67,000	13,500
8	80%	100,000	15,000	60,000	25,000	73,000	15,300
9	90%	100,000	15,000	60,000	25,000	79,000	17,150
10	100%	100,000	15,000	60,000	25,000	85,000	21,300
TOTAL					250,000	580,000	116,750

Tax bracket for year 10 is 85.2%.
Overall average tax bracket for 10 years is 46.7%.
Tax bracket of ordinary worker at same income is 18%.
Tax of ordinary worker at same income is $3,750.00

July 10 N

National Small Business Association

"The Voice of Small Business"

Founded 1937

STATEMENT SUBMITTED

ON BEHALF OF THE

NATIONAL SMALL BUSINESS ASSOCIATION

TO THE

SENATE COMMITTEE ON FINANCE

HOLDING HEARINGS ON

THE IMPACT THE PRESIDENT'S TAX PROPOSAL WILL HAVE ON SMALL BUSINESS

JULY 10, 1985

"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.

NSB Building • 1604 K Street, N.W. • Washington, D.C. 20006 • Telephone (202) 293-8830

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NATIONAL SMALL BUSINESS ASSOCIATION
TO THE
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THE IMPACT THE PRESIDENT'S TAX PROPOSAL WILL HAVE ON SMALL BUSINESS
JULY 10, 1985

This testimony is being submitted on behalf of the National Small Business Association (NSB), a multi-industry trade association representing approximately 50,000 small business firms nationwide.

We appreciate the opportunity you have given us to submit to you some of the views of small business regarding the President's Tax Plan. The 461-page document, covering approximately 150 issues, is still being studied as to its overall impact on the small business community since it is the most far-ranging tax bill since the Code was recodified in 1954.

The goal of the President's Tax Reform Proposal is to achieve tax simplicity and fairness for all taxpayers, individuals as well as businesses. The Proposal is constructed to be revenue neutral.

Revenue Impact

In the recent past, several members of the Senate Finance Committee have raised serious doubts as to the accuracy of projected revenue losses or gains that might result from the overall bill and particular provisions. We may all agree that a tax bill should be revenue neutral but the Finance Committee's job in achieving revenue neutrality will be difficult since the present package appears to lose about $19.5 billion over three years, if grandfather clauses are included, as they should be in fairness.

Equality of Treatment Within the Business Community

Since the capital recovery provisions would increase taxes for both large and small businesses to the extent they purchase tangible assets, the offsets of the bill for small business should be comparable to those for large business.

The most recent Administration's plan reinstitutes a graduated tax structure while reducing the number of tax brackets from five to four. This restores tax allocation parity between small and large corporations. Any analysis of the tax proposal's net effects must compare those items impacting taxable income, tax credits, and tax rates. The proposed 4-bracket system is shown below.

Chart I

Corporate Taxable Income	Tax Rate
$ 0 - $ 25,000	15%
$ 25,001 - $ 50,000	18%
$ 50,001 - $ 75,000	25%
$ 75,001 - $140 000	33%
$140,001 and above	Lower bracket rates phased out as taxable income increases above $140 K until a flat rate of 33 percent is achieved for income above $360,000.

The relative impact of the tax proposal for corporations can best be shown by the chart below

Chart II

Taxable Income*(1)	Current Law	Treasury I	President's Proposal
$ 25,000	$ 3 750	$ 8,250	$ 3 750
50,000	8,250	16,500	8,250
125,000	37,250	41 ,250	31 ,000
1,000,000	439,750	330,000	330,000

*(1) No attempt is made to adjust taxable income levels for revenue base broadening measures covered under Treasury I and the President's Proposals.

For example, the resultant tax liability of a corporation with taxable income of $75,000 is 41.4 percent less than the tax liability if calculated under Treasury I's flat rate and 7.9 percent less than current law.

The continuation of a system of graduated tax rates as first proposed by members of this committee would provide a better basis for small businesses to retain an equitable federal tax share.

The effective date for corporate tax rate changes under the President's plan would be July 1, 1986. Additionally, the corporate tax rates (unlike the individual tax rates) are not indexed (tied to an inflation factor).

Sole proprietors and small businesses operating in parternership form are similarly benefited by the reduction in individual tax rates. For example, the Administration's tax proposals when compared to current law (with respect to tax rate comparisons only) would produce a 21 percent reduction in individual income tax liability at $60,000 level of taxable income (married filing joint), one wage earner. This savings can be used to start or increase investments in smaller firms.

The small business sector, a leader in net new job growth, is being afforded an opportunity to obtain new capital as a necessary fuel for growth.

Investment Tax Credit

Under the President's Proposal, the investment tax credit (ITC) would be repealed. The original intent for implementing the ITC was to stimulate levels of investment in machinery and equipment and to prevent erosion of capital investment by inflation. The analysis espoused in the President's Plan illustrates that investment tax credit has biased investment in favor of certain "qualified" investment property to the detriment of other investment opportunities in a broader range of industries. It is also felt that the complexity associated with ITC would be eliminated while the basic intent for its use would continue through indexing and the proposed capital cost recovery system (CCRS).

Generally, the investment tax credit would be repealed for all assets placed in service on or after January 1, 1986.

Limited Use of Cash Basis

Those small business tax payers that have used the "cash method" of tax accounting (cash receipts and disbursements) will find some new stringent parameters as to the limited availability of cash basis tax reporting set forth in the new tax reform proposal.

The magnitude of this section in terms of impact on small business operations is wide in its scope. Its implementation by small business may be extremely costly. The targeted "cash method" taxpayers who will be drawn into an accrual basis tax reporting process appears somewhat ill defined as to intent but quite clear as to language. The relevant chapter of the Proposal (Chapter 8.03) states, "A taxpayer would not be permitted to use the cash method of accounting for a trade or business unless both of the following conditions are satisfied: (1) the business has average (determined on a 3-year moving average basis) annual gross receipts of $5 million or less (taking into account appropriate aggregation rules); and (2) with respect to a trade or business (other than farming) no other method of accounting has been used regularly to ascertain the income, profit, or loss of the business for the purpose of reports or statements to shareholders, partners, other proprietors, beneficiaries or for credit purposes."

Clearly, small businesses with less than $5,000,000 average annual gross receipts but who regularly use "accrual" basis reporting to owners, or creditors will be forced into the more immediate world of accrual basis tax reporting. The public policy intent to include a greater number of smaller businesses for this dramatic accounting shift is unclear in that the analysis discusses the number of cash basis businesses with gross receipts in excess of $5,000,000 but does not detail the number of cash basis reporting businesses under $5,000,000 who utilize accrual accounting for internal and external reporting.

The effective date for this provision will be for tax years beginning on or after January 1, 1986. The adjustment between cash and accrual methods is to be accounted for ratably over a period not to exceed six years.

Small business' chief adversary has always been cash flow. The obstacle for small business converting to accrual basis tax reporting is, "How do I pay income taxes now based on monies received next year?" "What if the accrual accounts are not paid or not paid on a timely basis?" These are questions which must be addressed to determine the impact of converting to tax accrual reporting method.

Capital Cost Recovery System - CCRS

The new capital cost recovery system contains several major departures from current accelerated cost recovery gudelines. These changes include:

1. Asset bases that will be inflation indexed annually;
2. Six asset categories would replace the current five categories; and
3. Recovery rates and period are designed to be investment incentive neutral.

Indexing depreciable assets will give small business protection against inflation induced capital asset erosion. During periods of inflation, small business will be able to take larger CCRS deductions against current income than would be available under a non-indexed system. The impact of this provision is best explained through an example:

A $1,000 investment in a CCRS Class I category (five-year) would yield cumulative depreciation deductions (nominal dollars) of $1,000 under current ACRS while CCRS amount would be $1,065 assuming a 5 percent inflation rate.

One area of possible concern for capital intensive small businesses is the treatment of depreciation "recapture", i.e., how much more will have to be paid in taxes? Forty percent of a taxpayer's "excess depreciation" will be added to taxable income during a three-year period starting in 1986. The recapture of "excess depreciation" is to be 12 percent in 1986, 12 percent in 1987, and 16 percent in 1988. "Excess depreciation" is defined as the excess of depreciation deductions taken between January 1, 1980 and July 1, 1986 over cumulative depreciation deductions based upon straight-line method.

However, certain recapture thresholds have been proposed in order to mute the impact of recapture. Cumulative depreciation deductions between the six-year period beginning January 1, 1980 and ending December 31, 1985 of <u>less than $400,000</u> will exclude taxpayers from excess depreciation recapture. If the taxpayer has aggregate depreciation deductions above $400,000, he may exclude from recapture the first $300,000 of <u>excess depreciation.</u>

The ability to immediately write off <u>up to $5,000</u> of qualifying business property has been retained in the proposal - but would be frozen.

<u>Inventory Indexing</u>

The FIFO (first-in, first-out) method assumes that the first goods purchased or produced are the first goods sold. Under FIFO the most recently purchased or produced goods are deemed on hand at year-end, and ending inventories are valued at the most recent purchase or production costs. LIFO (last-in, first-out) however, assumes that the <u>last goods</u> purchased or produced are the <u>first goods</u> sold. Since LIFO accounting values ending inventory at the oldest purchases or production costs, in periods of increasing costs, LIFO results in a higher cost of goods sold and lower taxable income than FIFO.

Under the new proposal, taxpayers would have available an inflation indexed FIFO inventory system in addition to LIFO and regular FIFO.

During inflationary periods, small businesses would be benefited by a higher cost of goods sold deduction afforded by an inflation indexed inventory method.

Application of an inflation indexer annually to the opening inventory of a first-in-first-out inventory system would be the extent of adjustments required. Small firms must pay close attention to the effect of changing from a LIFO method to an indexed FIFO procedure, particularly during periods of low or moderate inflation.

The effective date for availability of indexed FIFO inventory will be for tax years beginning on or after January 1, 1987.

Capital Gains Rate

The maximum net effective capital gains tax rate would be lowered for individuals from 20 percent to 17.5 percent under the Administration's Tax Plan.

A 50 percent exclusion of the net capital gain in conjunction with a maximum individual tax rate of 35 percent yields an effective capital gains tax of 17.5 percent.

Corporate investors would still retain the current 28 percent rate.

These changes should help spur new venture capital investing in our economy, particularly for start-up firms.

The proposed effective date for the capital gains exclusion is July 1, 1986. Certain transition rules outlining the integration of a blended rate with the exclusion are probable.

Other Provisions and Considerations

Interest income earned on industrial development bonds (IDBs) would be tax exempt only when the proceeds are used by a state or local government. For the small business utilizing IDBs for multi-family rental housing, pollution control, and other small-issue industrial financing this would mean higher interest costs due to these bond issues no longer being tax exempt. The proposed effective date for this provision is January 1, 1986.

State and local taxes would no longer be available as an itemized deduction. State and local taxes (other than income tax) incurred in a trade or business or income producing activity would be deductible as employee business expenses or other miscellaneous deductions (subject to a 1 percent of Adjusted Gross Income threshold). Effective for taxable years beginning on or after January 1, 1986.

Under current law, the proceeds from the sale of depreciable business property (Section 1231 property) are eligible for capital gains treatment on net gains, subject to depreciation recapture. The Tax reform proposal would tax as ordinary income the gain on the sale or disposal of any depreciable or depletable business property. Gains from involuntary conversions when reinvested in similar property may be deferred as under current law. Land used in a trade or business would, however, receive capital gain and ordinary loss treatment.

These changes would become effective for assets placed in service January 1, 1986 or later.

Interest

We are pleased that the Treasury I proposal for limiting business interest deductions (and income) to the real interest rate has been dropped. We believe the law will be far simpler if trade or business interest would be fully deductible by the borrower, whether or not incorporated, and includable as income by the lender, as under the President's Proposal.

This is another major benefit of this proposal to small and entrepreneurial businesses, which are commonly highly leveraged.

The personal interest deduction limitation action to $5,000 over and above investment income (as in the Treasury I Proposal) does not effect the operation of small enterprises but does effect the ability to borrow for the purpose of buying out a co-owner. This aspect of the Proposal should be examined.

Dividends

The President's Proposal is that 10% of dividends would be deductible. Treasury I proposed that 50% of dividends be deductible. Presently no dividends can be deducted.

A rough estimate is that small corporations (taxable income of less than $100,000) would pick up a tax savings of slightly less than 10% of the $24.8 billion in benefits from the provisions over the 5-year period. We are open minded on this proposal.

Employee Benefits

The President's Proposal would include a more limited amount of health insurance in taxable income ($300 per year per family, $120 per year for individual coverage). Our understanding is that the revenue impact would be a tax increase of $17.4 billion over the $5-year period, compared to $34.4 billion under the Treasury I Proposal.

A $5,000 death benefit exclusion would also be repealed, for a nominal revenue pickup of about $100 million over five years.

We are glad that Section 401 (K) plans, also called "cash or deferred arrangements", would be preserved, with employee contributions limited to $8,000, less any IRA contributions, and other technical changes added.

We also favor preserving cafeteria plans provided the non-discrimination requirements of the proposal are fair to small as well as large businesses.

Minimum Tax

The President's Proposal includes a new alternative minimum tax for both corporations and individuals, pursuant to the rationale that all taxpayers should pay a "fair share." This assures there will be debate on this matter and we welcome the debate since we do not have sufficient information to draw a conclusion on how this provision would impact smaller enterprises.

Entertainment expense would no longer be deductible business expense under the Administration's tax proposal. Business meals would have a $25 per person per meal cap with 50 percent of the excess above $25 being non-deductible. Christmas parties and summer company parties would still be deductible. Effective date for this proposal is January 1, 1986.

Again, the small business person should exercise care in determining the impact of these proposed changes for 1986. Certain credits and deductions would be repealed January 1, 1986; however, the tax rate reductions are effective July 1, 1986. The net effect could be a tax increase for 1986.

SUMMARY

The future of tax reform will be a decision made by this committee. Small businesses currently face a plethora of tax regulations and laws affecting their operations. These burdens affect the availability of cash and the ultimate cost of doing business. When business decisions are based on tax considerations rather than business concerns, success very often depends on familiarity with provisions of the many laws and regulations.

Many such inequities pervade our tax laws today President Reagan has proposed elimination of many inequitable tax provisions and credits by translating them into a system of uniformly lower tax rates.

Small firms of every description and at every level of their growth cycle must become very familiar with these proposed revisions and comment on their individual impact. As with any significant public policy change, there will be areas of improvement and fine-tuning to the President's plan. We must have a law that provides equality, fairness and revenue neutrality. The proposal before you is an important step toward tax fairness for small business. We are confident the committee will consider our recommendations that will provide fairness between large and small business.

We are also including, as exhibits, charts comparing the President's Proposal to existing law and prior law in the corporate rate and capital gains tax areas.

Attachments: Chart III: Effect of Administration's Tax Reform Proposal
Chart IV: Historical Perspective

CHART III

EFFECT OF ADMINISTRATION TAX REFORM PROPOSAL ON SMALL CORPORATIONS
Composite Rate Comparison

Taxable Income	Existing Law Composite Rate	Treasury I Composite Rate	% Diff. from Existing Law	Administration Composite Rate	% Diff. from Existing Law
$25,000	15.0	33	+120.0	15.0	0
50,000	16.5	33	+100.0	16.5	0
75,000	21.0	33	+ 57.14	19.33	-7.95
100,000	25.75	33	+ 28.16	22.75	-11.65
125,000	29.80	33	+ 10.74	24.80	-16.78
140,000	31.54	33	+ 4.62	25.68	-18.58
360,000	40.3	33	- 18.11	33.0	-18.11
More than 1,405,000	46.0	33	- 28.26	33.0	-28.26

CHART IV

HISTORICAL PERSPECTIVE ON TAXES APPLYING TO CERTAIN CORPORATE TRANSACTIONS

From 1980 to 1985 Proposal

Corporate Taxes	1980 Composite Rate	1985 Proposal Composite Rate	% Change 1980-1985 Proposal
$25,000	17.0	15.0	-11.76
50,000	18.5	16.5	-10.81
75,000	23.33	19.33	-13.43
100,000	26.75	22.75	-14.95
125,000	30.40	24.50	-19.40
140,000	37.0	25.68	-30.59
1.5 M and over	46.0	33.0	-28.26

Capital Gain Taxes	1980 Maximum Rate	1985 Proposed Maximum Rate	% Change
Personal rate	28.0	17.5	-37.5
Corporate	28.0	28.0	---

July 10 ✓

NASBIC

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

1156 15TH STREET NW • SUITE 1101 • TELEPHONE (202) 833 8230
WASHINGTON, DC 20005

STATEMENT OF

WALTER B. STULTS

Before the

SENATE FINANCE COMMITTEE

July 10, 1985

SUMMARY OF STATEMENT

1. Long-term capital gains tax rate differential is essential factor for economic growth, especially for new and growing businesses.

2. Corporate capital gains tax rate should be lowered to parallel rate for individuals.

3. Special tax provisions for small business and incentives for investment in business growth should be maintained.

STATEMENT OF WALTER B. STULTS

National Association of Small Business Investment Companies

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Thank you for this opportunity to present this statement on the Administration's comprehensive tax proposal.

I am Walter B. Stults, President of the National Association of Small Business Investment Companies (NASBIC), the national trade association which represents the overwhelming majority of all small business investment companies (SBICs).

Our members are privately-owned and privately-managed venture capital firms which provide equity capital and long-term loans to new and growing small business concerns. SBICs are licensed by the Small Business Administration and operate under regulations issued by SBA. Today, there are some 390 active SBICs with total assets of over $2-billion. During the 26-year history of the program, SBICs have provided over $6-billion in venture capital to about 70,000 small business firms.

The Critical Importance of Capital Gains Tax Rates

For SBICs, as for all other investors in American business, the level of Federal taxation of long-term capital gains is by far the most important provision in the Internal Revenue Code. Irrefutable evidence abounds: a meaningful differential between tax rates on ordinary income and those on long-term capital gains guarantees the essential flow of equity capital to entrepreneurs trying to start new businesses or striving to expand their existing operations.

The "Laffer Curve" has been ridiculed by many. I can't vouch for its overall soundness, but I can surely speak for the venture capital industry when I say that the reduction of taxes on long-term capital gains in 1978 produced more revenue for the Federal Government. The Treasury Department took its traditional position at that time and told Congress that the cut in such taxes would "cost" the Nation billions in tax revenues. But what actually happened? Each year since 1978, the Treasury has taken in more revenues from long-term capital gains in spite of the cut in the tax rate on such income.

Remember, I am referring solely to the direct, or the "static" result of the cut: rates down, revenues up. I am not taking into account the "dynamic" impact of the reduction; that is, the additional Federal tax collections from the increased taxes paid by the businesses which received venture capital from our industry and equity capital from other investors.

On June 26, Don Ackerman presented testimony to your Committee on behalf of the National Venture Capital Association. His statement contained a number of charts and tables demonstrating the importance of venture capital to the birth and growth of innovative and job-creating companies -- and the direct correlation between capital gains tax rates and the supply of that venture capital. I shall not duplicate Mr. Ackerman's testimony, but I want to reiterate its validity and stress its essential role in our economic system.

NASBIC members were dumbfounded at Treasury I's frontal attack on the capital gains tax differential. We believed that the near extinction of venture capital sources between 1969 and 1978 had shown the absurdity of removing incentives for institutions and individuals to invest in growth businesses. Fortunately, wiser counsel prevailed and Treasury II (or Reagan I) calls for a continued differential for long-term gains. NASBIC applauds that reversal and strongly urges your Committee to resist any effort to shave further the difference between rates on long-term capital gains and rates on other income.

Capital Gains Tax Rates for Corporations

While strongly supporting the President's proposal on capital gains tax rates for individuals, NASBIC calls for parallel treatment for corporations investing in new or growing small businesses. Over 90% of all SBICs are organized and taxed as corporations, so they will receive no incentives from the Reagan measure. As a matter of fact, corporations providing venture capital have fallen behind in the tax area since 1978 when the rate on long-term capital gains was set at 28% for both individuals and corporations. The rate for corporate taxpayers remains at 28% today in spite of our urging since 1981 that the rates should be the same for both individuals and corporations.

The proposal you are considering actually would reduce somewhat the attractiveness of venture capital investments for individuals as well, since the exclusion would be cut from 60% to 50%. Today's differential for the highest paying individual taxpayers is 30%; under Reagan I, the difference would be cut to

17.5%. But look at the corporate side of the coin: today's differential is 18%; under Reagan I, there would be only a 5% difference between corporate tax rates on ordinary income and on long-term capital gains.

NASBIC strongly believes that this tiny differential will cause corporate taxpayers to curtail their investments in venture capital firms and in venture investments. This result will have a serious adverse impact not only on the SBIC segment of the venture capital industry (which is overwhelmingly corporate in form), but also will drastically reduce the flow of capital from corporations to the other segments of our industry. Stanley Pratt, publisher of Venture Capital Journal, estimates that more than 40% of all the capital now committed to the venture capital industry either comes from corporate investors or is held by corporate venture capital companies.

We urge your Committee to amend the President's proposal to establish parallel tax rates on long-term capital gains for corporations and individuals. Based on recent empirical evidence, we are convinced that this change will produce increased tax revenues for the Federal Treasury.

Other Features of Importance to Small Business

At this point, I should stress one basic fact of life recognized by every venture capitalist: no one in our industry can survive, let alone prosper, unless the small businesses in which we invest can thrive. Venture capital firms are minority investors in high-risk, high-potential entrepreneurial enterprises. We have to worry about taxes only if the companies in our portfolios grow and become profitable.

The Tax Act of 1981 marked a milestone for this Nation's entrepreneurs; it allowed them to plow back more of their revenues and their profits into their businesses. The liberalized and simplified depreciation schedules permitted them to utilize more of their cash flow for creating new jobs and expanding their productive capacity. In addition, incentive stock options allowed these firms to attract highly-qualified personnel, even though they could not match the salaries and fringe benefits offered by larger established competitors.

Unfortunately, the tax laws enacted in 1982 and 1984 reversed the pro-growth philosophy of the 1981 Act and Reagan I would restrict the viability of growth businesses even further. I grant that the reduction in the top corporate bracket from 46% to 33% is attractive, and we applaud the retention of the graduated corporate tax rate. On the other hand, we believe that the removal of the other incentives for reinvestment and growth exacts too high a price for that cut in the top rate.

Conclusion

Throughout this statement, I have tried to point out that tax incentives for economic growth are a wise investment in the Nation's future. Such concepts as "simplicity", "neutrality" and "level playing field" sound plausible, but the small business community generally and the venture capital industry in particular call for tax laws which create an environment in which young and growing firms can create jobs, produce innovative goods and services, and foster competition. We call for tax laws which promote vigorous economic growth. Everyone wins in such a situation -- even the tax collector.

COMMENTS OF PHILIP P. FRIEDLANDER, JR.

EXECUTIVE VICE PRESIDENT

NATIONAL TIRE DEALERS AND RETREADERS ASSOCIATION

CONCERNING

PRESIDENT REAGAN'S PROPOSAL FOR COMPREHENSIVE TAX REFORM

submitted to

THE COMMITTEE ON FINANCE

of the

U.S. SENATE

July 31, 1985

July 31, 1985

Mr. Chairman:

My name is Philip P. Friedlander, Jr. I am the Executive Vice President of the National Tire Dealers and Retreaders Association, a national nonprofit trade association representing approximately 5200 independent tire dealers and retreaders located in all 50 states. NTDRA's members are engaged in the wholesale and retail distribution of automobile and truck tires, the retreading of tires and the sale of related products and services.

Mr. Chairman, NTDRA is appreciative of this opportunity to have input into this committee's deliberations on the President's tax reform proposal, the most comprehensive tax reform proposal in perhaps the last fifty years. We commend you Mr. Chairman and the members of this committee for pursuing such an exhaustive hearing schedule in order to allow a broad participation by affected parties in your comprehensive tax reform effort.

President Reagan, even before his first term was over, sought to focus the nation's attention on the need for comprehensive tax reform. During his most recent State of the Union message and again in a nationally televised address he has put his administration in the forefront of the tax reform effort. But rather than just offering the nation rhetoric, the President has offered a concrete, exhaustive four hundred and sixty-two page document, a blueprint from which the Congress could begin its work. The President has made clear from the outset that his objectives are to simplify the tax code, to improve its fairness, and to amplify the codes capacity to stimulate economic growth. NTDRA and its membership nationwide applaud the President for his efforts and support wholeheartedly his stated goals. We believe the proposal which the President sent to the Congress is an excellent point of departure for this committee to begin its deliberations.

I would be remiss if I did not convey to this committee the feelings of disillusionment which the nation's independent tire dealers and retreaders, and no doubt the owners of other small corporations, felt when the so called Treasury I proposal was released to the public last November. The proposed abolition of graduated corporate tax rates was staggering. That reality, coupled with the reality that small corporations, currently paying at an average rate of between 15 and 20 percent, might soon be paying a flat rate of 33%, was enough to stun the small business community. The impact was especially disillusioning in light of the fact that small business had not shared proportionately in the tax relief afforded by the 1981 tax reform act.

But rather than being stunned, NTDRA and other small business groups reacted. NTDRA, individually as well as in cooperation with the Small Business Legislative Council, moved aggressively to make the Treasury and the White House aware that the Treasury I proposal, from a small business perspective, simply was not acceptable. On behalf of NTDRA's membership, I wrote to then incoming Treasury Secretary Baker, pointing out the disastrous impact a 33% flat corporate rate would have on the nation's independent tire dealers and retreaders, as well as other small corporations. I sought to make clear that more than just small business would be damaged. Burdening small business in the manner proposed would impact beyond the small business sector. The economy as a whole and the American people would be adversely affected.

In May of this year when the President's proposal was made public, a sense of euphoria swept the small business community. For the first time in memory, the executive branch endorsed a graduated corporate tax rate structure. In addition taxable income between $50,000 and $75,000 would be taxed at 25% rather than 30% under the President's proposal. The small business community breathed a collective sigh of relief. NTDRA and its membership, originally shocked that any administration could have proposed the dramatic small business tax increases contained in Treasury I, now had the feeling that we had indeed dodged a bullet. Not unlike other small business groups, we were grateful to the President, and remain so, for his personal intervention in helping correct some of the most glaring inequities of Treasury I as they applied to small business.

Mr. Chairman, I must frankly tell you that the initial euphoria which this association felt upon public release last May of the President's proposal has significantly subsided. Although limited in staff and resources, as are most small business trade associations, we have begun as best we can to try and at least massage some of the numbers available in the President's proposal. The results have raised some grave concerns.

Mr. Chairman, NTDRA recognizes that the political climate is right for shifting some of the nation's tax burden from individuals to the corporate sector. We realize that climate has been created in part by the media reporting that the corporate sector of the economy is paying a sharply reduced share of overall federal revenues compared to what it paid shortly after World War II. It should not be overlooked however that those stories usually fail to report that the corporate sector's share of the GNP has declined from 14% in 1950 to 6% today. But the mood in the country for levying heavier taxes on corporate America has also been the result of revelations that billion dollar corporations have in some years paid no taxes at all, desite the fact that they made millions in profits. NTDRA and its members share the indignation of the general public that the tax code would permit such occurences.

NTDRA and its members do not quarrel with the concept of broadening the tax base and removing existing loopholes if the result is tax simplification and reduced rates. The majority of NTDRA members cannot afford to pay for dozens of accountants and tax lawyers to scrutinize the tax code looking for possible loopholes or tax shelters. On the contrary Mr. Chairman, we can understand the public's growing perception that the tax code is unfair. We can understand the growing public sentiment that reform is necessary. We recognize as does the public, and no doubt the members of this committee, that the tax code with its present complexity is tantamount to a government make work program for the nation's tax lawyers and accountants. And the problem is not helped by Congress changing the tax code, virtually every year. These frequent changes force small business people to expend badly needed resources just to make sure they are complying with the law. Yes, the public justifiably wants reform and we at NTDRA share that sentiment. NTDRA members, recognizing political facts of life, are ~~willing~~ to accept their fair share of an increased corporate tax burden. However, we would appeal to this committee to insure that the allocation of that burden is done in an equitable manner.

As I mentioned earlier we do not perceive that the tax relief granted in the 1981 act was evenly distributed among the business community. But despite the fact that capital intensive, large businesses received the lion's share of the 1981 tax relief, it has been small businesses that have led the nation out of the worst recession in 50 years and into a sustained economic recovery. Of the eight million jobs created since December 1982, sixty-six percent were created by small business. Small business created those jobs without the benefit of massive tax relief. They did it despite the fact that they can't borrow at prime. They did it despite the fact that labor intensive small businesses are hardest hit by payroll taxes. They did it despite the fact that small businesses do not enjoy the same economies of scale as large businesses.

Before I leave this point I want to take cognizance of the fact that some on this committee, justifiably concerned about deficits, may look to small business as a possible source of new revenue. I would point out that in the process of contributing in such a dramatic way to job creation the nation's small business community has surely contributed its fair share toward deficit reduction. Due in large part to the job creation efforts of small business in the last three years, the nation's unemployment rate has declined from above ten percent to slightly above seven percent. The budget impact of a three percent reduction in unemployment can be put somewhere between seventy-five and ninety billion dollars. When looked at from that perspective I think the claim that small business has contributed to deficit reduction is not unreasonable. And the job creating role of small business becomes all the more significant when you realize that since 1981 overall employment at the nation's Fortune 500 companies has declined. Clearly small business has been the engine pulling the nation's economy. I would not think that this committee or your colleagues in the Congress would want to take any actions which would impose very serious additional burdens on the nation's small business community of which the nation's independent tire dealers and retreaders are a viable part.

Mr. Chairman, the message which has consistently come from the Department of the Treasury since last fall is that tax reform would include a significant reduction in the maximum rates paid by the corporate sector. However, treasury officials have made it clear that the trade off for reduced rates was base broadening. But, the administration has also pointed proudly to reduced rates as offsetting business losses suffered from loss of the ITC and changes in depreciation schedules. And Treasury is right, to a degree.

Mr. Chairman I would like to direct your attention to page 454 and 455 of the President's tax reform report to the Congress. You and the other members of this committee will note on page 454 that reducing the maximum corporate rate to 33% will result over the next five years, in a loss to the Treasury of $154 billion dollars. Viewed from another perspective that is a tax savings to large corporations of $154 billion. However, if you will look on page 455 of the Presidents's report, the Treasury figures reveal that the changes in depreciation will mean increased Treasury revenues of $26 billion over five years. In addition repeal of the investment tax credit will mean a net increase in Treasury revenues of $139.7 billion.

It is estimated that 10% of the benefits of ACRS and the ITC accrue to small corporations. If that is true then the combined loss to larger corporations as a result of repealing the ITC and adjusting depreciation schedules is just under $150 billion. However, as we have noted, that figure is more than offset by the $154 -illion in tax relief which larger corporations realize as a result of reducing the maximum corporate rate.

Small corporations on the other hand will incur roughly ten percent of the loss resulting from repeal of the ITC and adjustments in the depre ciation schedules. That loss is equal to about $16.57 billion according to the Treasury's figures. Small corporations will see that additional $16.57 billion in tax burden partially offset by a $2 billion savings in graduated rate reductions. It should be noted that corporation's with taxable income under $50,000 will realize no benefits from graduated rate reduction, while the nation's largest corporations realize a reduction in rates from forty-six to thirty-three percent.

Lets look at those numbers again. Large corporations more than offset their losses from repeal of the ITC and depreciation reduction by a positive $4 billion. The loss incurred by small corporations ($16.57) billion is roughly seven (7) times their gain from rate reduction ($2 billion). It is not inappropriate to ask "where is the equity". If the political climate is right for shifting a larger share of the tax burden from individuals to corporations, these figures make it clear which segment of corporate America is going to feel the brunt of that shift. It appears that it will not be those corporations who have reaped such large benefits from ACRS and the ITC in recent years. It doesn't appear to be that group of large corporations reported to have paid no income taxes some years. It appears that it won't be those large corporations who have made investment decisions based on principles of tax avoidance. Rather it appears that it may end up being the nation's smaller corporations like NTDRA's members.

Mr. Chairman I would point out that Treasury may generate all manner of figures pointing the degree of out tax relief being realized by small business under the President's proposal. And their figures will be correct. But those figures will probably reveal the benefits realized by the Mary Kay salesperson, or the Amway distributor or businesses that are sole proprietorships or partnerships. Those benefits will be realized on the basis of the tax relief that results from reducing the income tax rates for individuals. Eighty percent of small businesses are unincorporated. Indeed a small minority of NTDRA members are unincorported and will in all likelihood realize some benefits from individual rate reductions. However, it is clear, I believe, that small corporations are likely to bear the brunt of the proposal you currently have from the administration.

Mr. Chairman, we would simply ask that in reviewing the President's proposal and the other suggestions which you will have under consideration, that you take a long hard look at what is likely to happen in the aggregate to small corporations.

Perhaps one way to redress the inequities that NTDRA perceives in the administration proposal is to look at graduated rates for small businesses with up to $500,000 in taxable income. This was, if my memory serves me, the top priority of the last White House Conference on small business. I believe the idea still has merit today. But regardless of whether increased graduation of rates is the answer it is imperative that the increased burden placed on corporate taxpayers be allocated fairly.

Mr. Chairman, I hope, in expressing this basic and overriding concern, that we at NTDRA have not appeared overwhelmingly negative. There are key parts of the president's package which we view as important steps forward. For instance NTDRA enthusiastically endorses the proposal to allow small businesses the option of using an indexed FIFO method of accounting. Although last in first out accounting is a more accurate measure of income from the sale of inventories in a period of inflation, the advantages of LIFO have not been realized by many of NTDRA's members. This is due to the significant administrative and accounting burdens and their attendent cost inherent in converting from FIFO to LIFO. Many small businesses have foregone the benefits of LIFO because they view conversion as entirely too burdensome. The proposal to allow an indexed FIFO accounting system reflects a real understanding of the problems of small business in this specific area.

While in the accounting area, NTDRA would ask this committee to look at the feasibility of allowing small wholesalers and retailers with gross sales under $2 million dollars the option of using cash accounting. To quote from page 213 of the President's proposal, "The relative simplicity of the cash method justifies its use for tax purposes by smaller less sophisticated businesses for which accrual accounting may be burdensome." We agree that accrual accounting is burdensome to small business tax payers. If it makes sense to allow an indexed FIFO accounting system then it may make equally good sense to go a step further and allow small retailers and wholesalers the option of using cash accounting. The cost of such a proposal would probably be no more than allowing indexed FIFO. Moreover it could result in significant tax simplification for those small businesses least able to afford professional tax accounting assistance.

NTDRA would also like to go on record as endorsing the President's proposal to allow a deduction for 10% of dividends paid out by a corporation. While this proposal will produce only modest benefits for a limited number of NTDRA members, we believe it is sound in principle. It will help small corporations in general attract investors and inhance small business capital formation.

We would also like to point out this association's support for continued favorable tax treatment of long term capital gains. Such favorable tax treatment provides a meaningful incentive for outside investment in new and growing businesses. With the high rate of new small business failures, it is obvious that investing in small business can be a real financial risk. Investors who help to fuel growth in the small business sector deserve a meaningful return on their investments. The President's proposal to effectively reduce the maximum tax rate on long term capital gains to 17-1/2% is a common sense method of fueling investment and growth.

Whenever there are proposals to reduce the tax on long term capital gains there is always an immediate cry that it will result in loss of revenue and cannot be afforded. We would like to point out, as I am sure others have done, that the history of capital gains rate reductions indicates that the result is not a loss of revenues, but a gain.

In the decade of the 1970's capital gains tax revenues averaged roughly $5.5 billion dollars annually. It is interesting, I think, to note that that is roughly the same level of capital gains tax revenues realized by the Treasury in 1969, the year that the maximum capital gains tax was sharply increased. However, since the reduction in the capital gains tax rate in 1978, treasury revenues from capital gains taxes have risen steadily and significantly.

As you are probably aware, there is real concern among small business groups as to the impact of the president's proposal to tax unemployment benefits and workmen's compensation benefits. NTDRA member's businesses are very labor intensive. We fear that, if these program benefits are taxed, state legislatures, under strong pressure from organized labor, will move to increase program benefits so that employees will suffer no real benefits loss. If benefits are increased, then, no doubt, payroll taxes for unemployment and premiums for workmen's compensation will be raised. The result may be is that the well intended effort to equalize the tax burden among individual taxpayers will be reflected in the payroll taxes paid by employers. We would urge this committee to carefully analyze the ultimate impact of taxing these program benefits before approving such a change.

Likewise Mr. Chairman, NTDRA is concerned about the impact of treating a portion of the premium cost of employer provided health insurance benefits as taxable income to the employee. Small, labor intensive businesses have sought in recent years to improve the benefits package for their employees. If these benefits become taxable income to the employee, he or she no doubt will seek to avoid any loss of real income by insisting on a wage increase. The ultimate result could be that small labor intensive businesses, like those comprising NTDRA's membership, would have a powerful disincentive to improve or even retain employee benefits packages. And society will be the loser because it will mean an increase in the population having insufficient or no health insurance coverage.

Furthermore Mr. Chairman, we would ask your committee to look very carefully at the broad ramifications of increasing the tax burden of the nation's insurance companies. The insurance industry, as you know, has sought aggressively to enlist the aid of the business community in that industry's effort to avoid sharply increased taxation. This association is ill-equipped to render a judgement as to the proper burden of taxation which the nation's insurance industry should bear. However, I can tell you that the nation's tire dealers and retreaders are already paying astronomical rates for product liability insurance, and that's if they can find coverage at all. NTDRA's members, for their very economic survival, would be forced to oppose any change in the tax code which would have the effect of placing product liability insurance even further beyond their reach.

Likewise Mr. Chairman we would be concerned as to the impact that changes in the way insurance companies are taxed would have on property and casualty insurance rates. Insurance premiums, in all likelihood, comprise a higher percentage of the costs of doing business for small businesses than for larger businesses. We would urge this committee therefore to recognize the potentially adverse impact on small business when you consider possible changes in the tax burden of the insurance industry.

NTDRA would like to commend the President for leaving in place the very positive changes that have been enacted in recent years relating to estate taxes. We believe the current rules are working in a manner beneficial to the overall national interest and would urge this committee to leave the present structure in place.

We would like to raise a serious concern regarding the administration's proposal to change the current rules regarding bad debt reserves. As this committee is no doubt aware, one method for accounting for bad debts for accrual basis taxpayers is the reserve method. This is an accepted accounting method which is designed, at any time, to provide readers of financial statements with an estimate of what portion of the receivables, appearing on the books of a business will likely be collected. Under the accrual method of tax accounting used by retailers and wholesalers like NTDRA's members, income is recognized at the time that all events have occurred establishing the taxpayer's right to income and the amount of that income. Not withstanding, all businessmen and women know that some of the receivables generated by their businesses will not be collected. One method for accounting for these uncollectible amounts is to allow a deduction from income when a receivable becomes uncollectible. This necessitates a factual determination and, in many cases, has resulted in protracted litigation between taxpayers and the Internal Revenue Service. Alternatively, the tax laws currently allow a taxpayer to deduct reasonable additions to a reserve for bad debts. The object of the reserve method is to properly match income with expense. The administration proposes to eliminate this method for deducting bad debts and force all taxpayers to deduct bad debt only when receivables become uncollectible. We believe that the reserve method is a valid and better method for accounting for bad debts and is more equitable since it properly matches income with expense.

The Treasury's explanation as to why the reserve method is unfair does not direct itself to a proper consideration of how the bad debt reserve works. The explanation contained in the President's proposal stresses that the reserve method seems to allow compounding of deductions since the amount which is deductible depends upon actual experience in determining how much of the remaining receivables are uncollectible. Although at first glance, this may appear to be the case, on further reflection it must be recognized that in any system using an estimate, experience must be used to make the reasoned estimate. Here, experience with receivables is required. If a taxpayer can show that in comparison to the receivables that he collected during the year, 2% were uncollectible, is this not a sufficient basis to estimate that 2% of the receivables that have not yet been collected are also uncollectible? To deny a deduction under these circumstances, (1) results in significant mismatchings of income and expense, (2) accelerates the tax liability of a taxpayer starting or expanding his business and (3) creates additional administrative burdens to maintain the more detailed records required to show that a given receivable is not collectible, a particular administrative burden for the smaller business. Further, the reserve method results in a more level deduction for bad debts than the specific write-off method, resulting in less fluctuation in a taxpayer's taxable income and less fluctuation in revenues payable to the Treasury.

We must also express concern regarding the administration's proposal to impose immediate tax liability on taxpayers who depreciated assets under the accelerated cost recovery system, "ACRS". We feel that imposing a tax liability prior to the time that a taxable event occurs violates tax policy that has existed since the first enactment of the federal income tax laws.

We are aware of no other provisions of any tax proposals or revisions of prior tax laws which have attempted to create exceptions to the basic rule of realization where there have been changes in tax rates. Tax rates have been changed in the past and some of those rate changes have been as significant as the ones currently proposed. Nevertheless, no exceptions were made to require the realization and recognition of income because of those tax rate reductions.

NTDRA recognizes that the $400,000 exemption level contained in the President's proposal would exempt a very large percentage of our members. Nonetheless, we are compelled to oppose the recapture concept because it represents such a radical departure from traditional tax policy. The recapture concept would in essence punish a taxpayer for utilizing a section of the code which the government, in the hope of stimulating economic recovery, had encouraged business taxpayers to utililize.

NTDRA recognizes and supports the need, previously enunciated by other small business group, for changes in present payroll deposit rules. NTDRA believes the current threshold of $3,000 dollars is too low when one realilzes that payroll tax rates and the payroll tax wage base have increased considerably since the $3000 threshold was put in effect roughly five years ago.

The possibility that a small business might have to make up to eight payroll tax deposits a month is more than unnerving. It represents the potential for very real increases in administrative costs to small businesses. A threshold level of $5000 does not seem unreasonable. Moreover consideration should be given to indexing this threshold to increases in the payroll tax wage base.

Under current law expensing of assets is allowed up to $5,000. In addition there is a provision in current law to increase the level of expensing to $10,000 in 1990. The President has proposed freezing the level of expensing at $5,000. Expensing represents one of the most significant means of achieving simplicity in the tax code and we would question the wisdom of disallowing the scheduled 1990 increase to $10,000. Indeed we think the committee should look carefully at the benefits in terms of simplicity and economic growth, which might be derived from allowing small businesses a sharply increased level of expensing. While we do not have revenue loss figures to accompany such a suggestion we are certain the committee could readily obtain them. If the loss is relatively insignificant we think the proposal has real merit.

Before concluding, we would also ask the committee to recognize that large businesses can often better afford adjusting to changes in the tax code than can small businesses. When deciding the dates when proposed changes in the tax law become effective, we would urge you to consider the considerable length of time required by the IRS to promulgate tax code regulations. Imagine yourself as a small businessman or woman trying to make a business decision which may possibly be impacted by the tax code. You consult your accountant who tells you he doesn't know how to advise you because the regulations still haven't been written for tax law changes which have already become effective. Give small business adequate time to make adjustments.

Mr. Chairman we have expressed a broad array of concerns. This is necessitated by the fact that we don't know how this association's members will be affected when all the changes are ultimately in place. We would only ask that small corporations not be asked to carry a disproportionate share of the burden. We recognize the difficult job and perhaps thankless job with which you and your committee are faced. This association stands ready to offer any assistance that you or staff feel we can render. We certainly intend to try and cooperate in every way we can because we are committed to a tax package that holds out the hope of increased simplicity and fairness which can also sustain increased levels of economic growth. We reiterate our appreciation for the opportunity to present this association's views and wish you and your colleagues every success in the monumental task which confronts you.

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NORTHERN PLAINS RESOURCE COUNCIL

Field Office
Box 858
Helena, MT 59624
(406) 443-4965

Main Office
419 Stapleton Building
Billings, MT 59101
(406) 248-1154

Field Office
Box 886
Glendive, MT 5933
(406) 365-2525

TESTOMONY OF BILL GILLIN
NPRC FAMILY FARM TASK FORCE CHAIRMAN
U.S. SENATE HEARING ON TAX POLICY REFORM
SENATOR MAX BAUCUS PRESIDING
BILLINGS, MT, MAY 29, 1985

Thank you Senator Baucus for the opportunity to present the viewpoint of our group on the proposed changes in federal tax laws. The Northern Plains Resource Council (NPRC) formed a Family Farm Task Force approximately 18 months ago and has since been studying, in depth, the factors leading up to the present crisis in agriculture. The Task Force has been exploring possible actions and public policies that could restore agriculture to long-term health and assure the continuation of family owned and operated farms and ranches that have proven so successful in the past. The American people are the best fed people on earth and at a lower percentage of their income than any other nation now or in past history. This should be adequate proof of the success of this system and urgent need to preserve it. We are seeing in the present crisis a very real danger of the family farm or ranch becoming a thing of the past and the ownership and control of agricultural lands being concentrated in fewer and fewer hands with the dangers of monopolistic controls and the prospect of substantially higher food prices.

During our months of study we have found one common factor in almost all aspects of the present agricultural crisis, and that is the effect of federal tax laws as applied to agriculture. Those tax provisions that Congress has over many years put into the federal tax codes in attempts to help agricultural people have all too often been used by high income people for tax haven purposes and the end result has been a drastic negative effect on the bona fide farmers and ranchers.

An excellent example of this in Montana is the sodbusting that has become so common in recent years. Most of the sodbusting has occurred on low-grade land with high potential for erosion. The grain from these operations is being dumped on an already overloaded market. The demand for rangeland for sodbusting has caused the price of these lands to inflate to totally unrealistic heights, making it impossible for young ranchers to compete in buying ranching units.

We are submitting with our written testimony a study prepared by Montana State University on the economics of sodbusting This booklet will explain how the various tax loop-holes and exemptions have been used to finance these operations and make them very lucrative for high income people. Also included will be a list of the limited partnerships that have been involved in financing John Greytak's First Continental Corporation's sodbusting. This particular group is responsible fo plowing over a half-million acres of grass with the publicly announced intention of sodbusting over one-million acres. This activity occurring largely as a result of tax policy leads us to believe the tax laws are in dire need of revision if there is any hope of restoring agriculture to long-term financial health.

The abuse of legitimate agricultural tax exemptions by outside investors and speculators has convinced us that the farm program and federal tax revisions should be considered together. The use of agriculture as a tax haven has contributed to the boom and bust cycles so detrimental to family-owned and operated units. It has fostered speculation in land and livestock that intensifies the collapses when they occur, as we are currently experiencing. Investors can buy in and out of agriculture. Family farms get wiped out and often are permanently lost from the agricultural industry. These factors will persist without tax reform, regardless of how carefully Congress constructs a farm program aimed at keeping family farming paramount in America.

The limited partnerships and corporations that have become involved in agriculture in recent years are receiving an indirect subsidy from the federal government through tax write-offs. They are by no means more efficient than the family-owned and operated units, but they have approximately a two-to-one advantage over the full-time operators because of these tax write-offs. Then, to penalize the full-time operator still more, these tax haven operators are dumping more and more commodities on an overloaded market, running up the price of land and machinery to unrealistic levels, creating erosion problems, pumping excessive amounts of water from some of the nation's aquifers - even to the extent of depleting them, and putting long-time family-owned operators out of business. All of this is being sponsored and encouraged by the present tax codes. These same tax haven operations have also been the recipients of billions in agricultural support payments, causing farm programs to be discredited in the eyes of the tax-paying public.

Tax policy has been a factor in transforming the livestock industry in recent years dramatically. According to the Center for Rural Affairs, between 1980 and 1982, 30% of U.S. pork producers left the business. Many of these were small or medium-sized operations. In the past year, six major corporations announced expansions that will add nearly one million more hogs per year to U.S. production. In the hog industry, a 1% increase in supply creates a 2% decrease in price. The effect of the increased production on an average producer who sells 1,000 hogs per year would be a loss of $2,400. The rapid industrialization of hog production has closely paralleled tax policies, including such breaks as the definition of certain livestock buildings as "equipment" for tax break purposes.

The Congressional Joint Committee on Taxation recently estimated that farm tax shelters will cost the federal treasury $2.6 billion in revenue between 1985 and 1987. In these deficit-plagued times, this virtual hemorhhage needs to be stopped. Moreover, the deficit is no small contributor to problems of farmers faced with unprecedented high interest rates.

Specific tax provisions that foster off-farm investment in agriculture include: Capital gains; investment tax credits; depreciation (especially accelerated cost recovery system); cash accounting; defining certain livestock buildings as equipment; deductions for interest; and deductions for land conversion from grass to grain or irrigated farming. Many of these are legitimate deductions to the bona fide farmer or rancher operating under the current tax code, and are necessary under these circumstances. If any or all of these provisions are deleted under the pending tax reform proposals there must be a corresponding reduction in the overall tax rates so that these changes will not turn out to be punitive to present and future family farmers and ranchers.

For the time being we encourage the passage of legislation that would limit the amount of outside income that could be put into agriculture and thereby be exempted from federal income tax. We would recommend that this limitation be approximately equal to the national median income. This would allow a young couple getting started in agriculture to apply the income from one or both working off the farm to their agricultural enterprise without undue penalty.

Other short term solutions can also be implemented, pending comprehensive tax reform, that would help deter tax sheltering in agriculture. We urge you to support legislation that specifically addresses solutions to this serious problem.

Overall, we have arrived at the conclusion that the federal tax system is seriously flawed and needs comprehensive reform if this country is to maximize its resources, labor, and management skills. The well-publicized inequities of the current system have substantially undermined tax-payers' confidence that they are being taxed fairly.

In conclusion, let me reiterate that we favor revision of the federal tax codes, especially those provisions that are undermining family-owned and operated agriculture. The present system is tending to recreate in this country the feudal systems that plagued Europe for centuries and from which most of our ancestors fled when they came to America. The feudal systems of Europe were protected by regiments of soldiers or knights in armor, while what we are seeing created in this country are feudal domains protected by regiments of accountants and tax lawyers.

Thank you.

STATEMENT

OF

KURT M. SWENSON

PRESIDENT, NATIONAL BUILDING GRANITE QUARRIES ASSOCIATION

AND

TRUSTEE, THE BARRE GRANITE ASSOCIATION

SUBMITTED TO

THE COMMITTE ON FINANCE

UNITED STATES SENATE

FOR THE RECORD OF THE

COMMITTEE'S JULY 10, 1985 HEARING

REGARDING

THE IMPACT THAT THE PRESIDENT'S PROPSAL FOR TAX REFORM

WILL HAVE ON SMALL BUSINESS

STATEMENT OF KURT M. SWENSON,

PRESIDENT, NATIONAL BUILDING GRANITE QUARRIES ASSOCIATION

TRUSTEE, BARRE GRANITE ASSOCIATION

Introduction.

My name is Kurt M. Swenson and I live in Hopkinton, New Hampshire. I am the President of the John Swenson Granite Co., Inc., of Concord, New Hampshire, and Rock of Ages Corporation of Barre, Vermont. Both of these companies are engaged in the dimension granite business. As the President of the National Building Granite Quarries Association, and as a Trustee of the Barre Granite Association, I represent 33 companies in the dimension granite business. In addition, I am a businessman who is very familiar with the dimension granite industry throughout the United States. Although I cannot claim to speak officially on behalf of the entire industry, I am confident that the views expressed herein are fully shared by most members of our industry.

Repeal of percentage depletion for granite, as proposed by the Administration, will have a catastrophic effect on our industry. We are small businesses which constitute the economic mainstays of most of the areas in which we are located. Repeal will make it impossible for us to continue to modernize and compete with foreign imports, as our taxes will climb dramatically. To preserve the very existence of this segment of the small business community, the percentage depletion allowance for granite must not be repealed.

What we ask is far less than what is proposed for the "small business" segment of the oil industry, i.e., "stripper wells," which under the Administration's proposal will be permitted to retain percentage depletion as well as other important tax benefits not available to our industry. Fairness, a key aspect of the tax reform bill, requires that our small business group at least be allowed to retain its percentage depletion allowance.

The Dimension Granite Industry is Composed of Small, Family Owned and Operated Businesses.

Dimension granite is quarried in the form of large blocks of twenty tons or more. These are then sawed into panels, slabs, or other shapes according to specified measurements. Dimension granite products fall into three broad categories--building/construction, monumental, and curbing granite.

All of the companies which are members of the National Building Granite Quarries Association are small companies whose stock is not publicly traded. That Association consists of only eight companies, although these are probably the largest of the dimension granite companies in the United States. Among our members is the largest dimension granite quarrier and manufacturer in the United States, with sales of approximately $90,000,000 and about 1,200 employees, and the second largest, with approximately $30,000,000 in sales and 500 employees. None of the other members of the Association has sales of more than $20,000,000. The smallest has approximately 50 employees and sales of approximately $3,000,000. Many granite firms are not members of our Association because their businesses do not involve building granite, but rather deal with monumental granite, granite curbing, or other granite products. The Barre Granite Association is made up of 25 companies which manufacture and sell primarily granite monuments.

Nationwide, the dimension granite industry is composed entirely of small businesses. In addition, to our knowledge there is <u>no</u> member of the industry <u>anywhere in the United States</u> whose stock is traded on any exchange. Dimension granite companies are typically family owned and operated. For instance, all of the members of the National Building Granite Quarries Association are owned by the founders of their companies or their descendants, and, with one exception, each is managed by first, second, third or fourth generation family members. The same is true of the Barre

Granite Association. This pattern occurs throughout the industry.

<u>Repeal of the Percentage Depletion Allowance for Granite Will Devastate the Dimension Granite Industry, Destroying Businesses and Jobs, and the Communities That Depend on Them, Without Any Commensurate Revenue Increase, and These Effects Will be Felt Nationwide.</u>

As the representative of the National Building Granite Quarries Association and the Barre Granite Association, and as a businessman familiar with all facets of the dimension granite industry, I urge you to oppose repeal of the 14% depletion allowance for granite. Repeal will have a catastrophic effect on the small businesses making up the industry. Many will be forced to close permanently or to severely curtail production. Hundreds of jobs in the industry, and many more that depend on the industry, will be lost forever. In addition, whole communities will be devastated economically. These effects will far outweigh any apparent increase in revenue from the repeal of the depletion allowance for granite. Indeed, we estimate that the revenue pickup in the dimension granite industry from repeal will be minimal, raising directly no more than $5,000,000 in new tax revenue, and this direct increase in revenue will be largely or even entirely offset by the indirect loss in revenues that will flow from lost jobs and failed businesses.

According to the Bureau of Mines of the United States Department of the Interior, the dimension granite industry employs 9,600 people nationwide.*/ The major states in which granite is produced are Georgia, Vermont, Minnesota, North Carolina, South Dakota, Texas, New Hampshire, and Massachusetts. In addition, granite has been used in buildings in every state, including many of the buildings here in Washington. There are also approximately 4,000 dealers selling granite monuments in all 50 states who employ more than 20,000 people. We estimate that the dimension granite industry and related businesses employ least 35,000 workers. The jobs of many of these people are on the line if percentage depletion for granite is repealed.

<u>The Gross Unfairness to the Small Businesses Comprising the Dimension Granite Industry is Highlighted by the Favorable Treatment Accorded to Oil and Gas Small Businesses (Stripper Wells).</u>

The magnitude of the economic impact which the repeal of percentage depletion will have on the dimension granite industry, and its manifest unfairness, is dramatically illustrated by an examination of the tax treatment which the

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*/ The Bureau of Mines has just published an extensive analysis of the dimension stone industry in Bulletin 675, MINERAL FACTS AND PROBLEMS, (preprint 1985), from which this employment figure is taken (p. 6). This report is referred to hereafter as "Bureau of Mines Report."

Administration's tax proposals accord stripper wells, our industry's "small business" counterpart in the oil and gas industry.

Under the current Internal Revenue Code, the oil and gas industry is entitled to deduct intangible drilling costs in the year incurred. The current deduction of these costs, which under generally accepted accounting principles must be capitalized, is a significant tax benefit. This deduction is a principal means whereby smaller oil and gas producers obtain capital to enable them to function. This tax benefit will not be touched by the Administration's proposals for a "reformed and fair" tax. The dimension granite industry is not benefitted now, nor under the Administration's proposal, by anything resembling this generous deduction for intangible drilling costs. Under the tax accounting treatment accorded our industry the very substantial costs of developing a granite quarry must be capitalized and written off over the useful life of the granite reserves, usually 40 or 50 years.

The percentage depletion provisions also highlight the differential treatment of small businesses in the oil and gas industry as opposed to small businesses in the domestic granite industry. The small business segment of the oil and gas industry, operating stripper wells, has the benefit of a

15% deduction for percentage depletion under the present law. Under the Administration's proposal, these same small businesses would retain that depletion allowance. By contrast, under present law, the dimension granite industry's small businesses can deduct 14% of their annual income from mining under percentage depletion. But in striking contrast to the treatment afforded oil and gas small businesses, the Administration's proposal would take percentage depletion from our industry.

<u>The Administration's Rationale for Retaining Percentage Depletion for Stripper Wells Also Requires the Retention of Percentage Depletion for the Dimension Granite Industry.</u>

The Administration's proposal justifies the retention of percentage depletion for stripper wells because repeal

> could have a significant adverse effect . . . . Recent declines in oil and gas prices have strained the profitability of [stripper wells]. . . . A change in existing law to deny percentage depletion could make many stripper wells unprofitable on an after-tax basis and result in their early abandonment. A significant decline in stripper well production could, in turn, increase the country's dependence on foreign energy, [and] exacerbate the problem of the trade deficit. . . .

These comments apply with equal force to the dimension granite industry. Prices have remained stable in the industry over the last twenty years,*/ although costs,

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*/ Bureau of Mines Report, p. 5.

particularly for labor, have gone up. This, coupled with increased foreign competition, has "strained" the profitability of our industry. Removing the percentage depletion allowance for granite will most certainly result in abandonment of the business by many small dimension granite companies. Imports of cheap foreign products would rise, thus exacerbating the United States trade deficit. Except for the "national security" justification, the Administration's rationale for retaining percentage depletion for stripper wells justifies with equal force retention of the percentage depletion allowance for the dimension granite industry.

Consequently, at the end of a reform process designed to insure "fairness," small businesses in the oil and gas industry would retain their historical tax treatment in the form of intangible drilling cost deductions and percentage depletion allowances, while small businesses in the dimension granite industry would be deprived of their only significant tax relief, critical to their survival--percentage depletion.

Elimination of Percentage Depletion for Granite Would Cripple Our Industry's Ability to Generate Capital. Cost Depletion is Not A Viable Alternative, and Normal Sources of Capital are Closed to Our Industry.

Cost depletion, which would become the sole tax relief for all mineral producers except those operating stripper wells, is not a viable alternative in our industry, because it results in a very long cost recovery period. Cost depletion involves estimating the total reserves of granite on the property and dividing that figure into the total costs for the land and the granite reserves. Since granite reserves are almost always measured in terms of a 50-year supply, the cost depletion method results in a cost recovery period of 50 years. For example, if a quarry costs $4,000,000 and its estimated reserves are 10,000,000 cubic feet, the allowance for cost depletion would be 40 cents for each cubic foot sold. If 200,000 cubic feet per year were sold, the cost depletion allowance would be $80,000 per year. Consequently, an investment of $4,000,000 made in 1985 would not be recovered for 50 years under the Administration's proposal. With the repeal of percentage depletion, the granite industry would undoubtedly have the longest cost recovery period of any business.

To compound the damage, the value of the land used for quarries does not appreciate, it depreciates. Oil or gas producing property is not defaced permanently by the recovery process. When an oil or gas reservoir is depleted, the wells can be plugged and the equipment removed, and the land can be sold for commercial or residential development or farming. By contrast, granite quarrying leaves very large holes in the ground and once the granite is depleted, the property is worthless. A businessman who makes an investment of $1,000,000 in land and $3,000,000 in plant (excluding equipment) may depreciate the building over a period of 20 years or $150,000 per year. With proper maintenance, the same land and building in a 5% inflationary economy would have a value of approximately $8,000,000 in 25 years. A similar investment in a granite quarry clearly cannot create such a return for the producer.

As is evident, the Administration's proposal would impose a severe hardship on the dimension granite industry by eliminating a deduction that allows recovery of the substantial costs incurred in developing a granite quarry. What makes this hardship even more severe is that <u>every</u> company in the dimension granite business is a truly small business. Many are sole proprietorships or partnerships and none are corporations with publicly traded stock. They are almost all family owned enterprises. None of them have ready access to capital markets to raise equity or obtain other favorable financing. The members of the dimension granite industry must raise the required funds for capital expenditures through earnings and borrowing from banks, generally the most costly form of financing for small businesses.

The Dimension Granite Industry Cannot Simply Raise Prices Because of Fierce Foreign Competition Fueled by the Strong Dollar.

Some might initially be inclined to think that the impact of the repeal of the percentage depletion allowance for granite is not really important to our industry because we can simply raise prices to offset the adverse consequences of repeal. That no such simple remedy is available to us, however, is best brought home, I believe, by a description of the harsh realities experienced by my family's company, an experience shared, unfortunately, by many in our industry.

The Swenson Granite Company was founded in 1883 by my great grandfather. Over the past century his sons, grandsons, and their sons have continued to build the business on the foundation he laid. By the mid-1960s, the Swenson Granite Company was the second largest supplier of dimension building granite in the United States. Even so, the total sales volume of our company at that time, when things were booming, was only approximately $4,000,000.

Beginning in the early 1970s, the building granite industry began to encounter very severe competition from imports, principally from Italy. This was due in large measure to the fact that the Italian Government did then, <u>and does now, provide direct grants of more than 50% of the</u>

capital cost of granite manufacturing equipment to Italian granite manufacturers. Because Italian manufacturers have to recover such a relatively small portion of the cost of their investment in equipment, and because they enjoy lower labor costs, they are able to set their prices to the United States market substantially below those of United States producers.

When I became the chief executive officer of our company in 1974, it was on the brink of closing. We had gone from prosperity to virtual bankruptcy in one short decade. We employed approximately 200 people in the Concord, New Hampshire, area at that time. I had no other choice but to close the building granite division and lay off permanently almost 150 workers, reducing our work force to approximately 50.

In view of our precarious financial plight we filed applications with the International Trade Commission for assistance. After a hearing here in Washington we were found to be substantially injured by imports under the provisions of the 1974 Trade Act. Subsequently, and after great expense and long delays, we were finally given a loan under the Trade Adjustment Assistance Program for approximately $250,000, at the then-high interest rate of 10-1/8%.

In the difficult days of the mid-1970s, I testified here in Washington before a number of Committees on bills to improve the Trade Adjustment Assistance Program, when it became clear to me that no administration was going to take action to protect our industry from unfair subsidized foreign competition. also appeared before the House Ways and Means Committee in an effort to have Congress extend the tax net operating loss carryback period for companies which had been injured by imports. We met with little success because, I believe, we are just small businesses and so failed to get our message across.

Through a lot of hard work and a total redirection of our company from building granite to granite curbing and granite blocks for monumental and building use, our company survived. It took us almost ten years to recover financially. However, our employment level in the Concord area never recovered, and is still 50 people as compared to the 200 people we previously employed.

I have a great deal of pride in the fact that our company was not only the first of those that received a loan under the Trade Adjustment Assistance Program to make each repayment on time, but was also <u>the first and only company ever to prepay a Trade Adjustment Assistance loan</u>. In March 1984 we paid the government back in full--five years before our loan was due.

Imports Have Devastated the United States Dimension Granite Industry.

But our company was one of the lucky ones. Scores of companies in the building granite business have gone bankrupt or terminated their business operations as a result of imports. According to statistics provided by the Department of the Interior, although total demand for dimension granite in the United States, measured in terms of tons of stone, rose 3.5% in the decade from 1973 to 1983, the proportion of that demand satisfied by imports rose 248%.*/ This is an alarming displacement of domestic production in a mere decade.

But if imports measured by weight present an alarming picture, imports measured in terms of value present one that truly staggers the imagination. As the table below illustrates, in the six years from 1977 through 1983, the average yearly increase in imports by value was 66.7%. This results in a phenomenal increase of 1,770% over the six-year period--a factor of almost 18. These startling figures reflect a shift in the composition of imported dimension

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*/ These figures are based on data supplied in the Bureau of Mines Report, p. 4. In 1973, imports accounted for 11.4% of United States consumption by weight, while in 1983, they accounted for 28.2% by weight. Approximately two-thirds of the dimension granite imported currently comes from Italy.

granite from unfinished blocks requiring further manufacturing in the United States to finished granite products ready for the retail market.

Imports of Dressed Dimension Granite by Value
1977-1983

Year	Value */	% Increase in Value Over Prior Year
1977	4,610	----
1978	5,672	23.0
1979	9,713	71.2
1980	18,383	89.3
1981	33,521	82.3
1982	71,637	113.7
1983*/	86,183	20.3

*/ Value in 1,000's of dollars. Figures for 1983 are projections based on actual results through September.

Source: Imports IM 146, TSUS item 513.74 (microfiche), Bureau of Census, U.S. Department of Commerce.

The results of this foreign competition have been devastating to the dimension granite industry. Total lost jobs in the building granite industry over the last 20 years are estimated to be in excess of 20,000. Compounding this problem, we have not had the benefit of negotiated agreements on imports (as has the automobile industry) or of pricing controls (as enjoyed by the steel industry). As cynical as this may sound, it would appear that this has happened because we are such a small voice--members of a small business community whose companies and employees are either unnoticed or simply considered dispensable.

The problem is not confined to building granite, and it is a growing one. At this very moment, imports of finished granite monuments and other granite products are on the increase. Countries with high unemployment, including Portugal, India, Spain, and Brazil, have enacted legislation providing incentives to dimension granite producers in those countries to build manufacturing facilities and export their products. These incentives, in the form of grants and favorable tax treatment, combined with very low wage rates, have resulted in shipments of finished monuments and other granite products coming into this country at an unprecedented level. The very strong dollar has had the effect of intensifying this import competition.*/

The Dimension Granite Industry Has Aggressively Met the Threat of Foreign Competition, but Repeal of Percentage Depletion Will Nullify Our Efforts.

The granite producers of the United States have not meekly submitted to this foreign competition. Nor have they turned to Congress for assistance. Instead, over the last two years, the members of the dimension granite industry have invested millions and millions of dollars in new

*/ Bureau of Mines Report, p. 6.

technology in an effort to preserve and protect the United States industry and its employees. To our complete dismay, at this most critical time in our beleaguered history, Congress is being asked by the Administration, in a tax reform proposal heralded as promoting simplicity and fairness, to put the final nail in the coffin of the domestic dimension granite industry.*/

The Administration's Tax Proposal Would Increase by Almost Two-Thirds the Actual Taxes Paid by Dimension Granite Companies.

In order to give you an idea of the impact of repeal of the 14% depletion allowance for granite on The John Swenson Granite Company, Inc., I have provided a table below which compares the tax imposed on certain ranges of earnings for 1984 to the tax that would be imposed after the repeal of the depletion allowance and a reduction of the corporate tax rate to 33% as provided for in the Administration's proposal. Strikingly, the John Swenson Company, at its current earnings level, would have a tax increase of 63%. If its earnings were higher, the dollar increase and the percentage increase would both be lower. Clearly, the Administration's "reform" proposal penalizes smaller

*/ Our industry's program to modernize so as to compete effectively with foreign competition will also be severely undercut by the Administration's proposal to end the investment tax credit.

companies, such as those in our industry, far more than large corporations. Further, these increases would be higher to the extent that the tax rate actually established by Congress is in excess of 33%. The impact of the Administration's tax proposals is similar on our affiliated company, Rock of Ages Corporation, and is probably similar for all granite quarriers in this country.

Estimated Tax Consequences from Repeal of Granite Depletion

The John Swenson Granite Company, Inc.

Pre-Tax Earnings	Current Tax	Tax at 33%	Dollar Increase	% Increase
$ 824,000*/	$167,000	$272,000	$105,000	63%
1,300,000**/	340,000	429,000	89,000	26%

*/ 1984 actual earnings.

**/ For illustrative purposes only.

In short, this segment of the small business community, instead of benefitting from a reduced tax rate, would see its tax burden increase by almost two-thirds. It is also important to remember that the dimension granite industry currently pays taxes; it is not one of those industries that, through special tax breaks, avoids paying any tax. These totally tax-free industries are the true targets of the fairness objectives of the Administration's proposal, not an industry such as ours.

<u>Profiles of 'Areas Dependent on the Dimension Granite Industry That Will be Devastated by Repeal of Percentage Depletion for Granite.</u>

I would like to profile four areas of the country, typical of the more sparsely populated and poorer rural areas in which most granite is located, that would be most severely affected by the repeal of the percentage depletion for granite. We ask this Committee to consider whether it is worth the very small amount of revenue which will be gained from repeal to put these already hard-hit areas of the United States at risk.

<u>Georgia.</u>

Elberton, Georgia, is a community of 6,000 people. There are about 150 family owned and operated companies in Elberton in the dimension granite business. Almost all of these companies have sales below $1,000,000. Our industry in Elberton employs a total of 1,800 people and has aggregate sales of between $50,000,000 and $70,000,000. Sixty percent of the non-farm wage earners in the Elbert County area of Georgia are employed in the dimension granite industry. With support services and suppliers, the total economic impact of the industry in the Elbert County, Georgia, area (using a multiplier of 3) is somewhere between $150,000,000 and $200,000,000 per year. This industry has been the economic mainstay of this part of Georgia since approximately 1910. An area such as this cannot easily absorb the loss of jobs and income that would result if only a portion of the dimension granite companies there should cease operations; rather, with no other major industry to create employment, a loss of even a quarter of the jobs in the granite industry would create Depression-era conditions in Elbert County.

<u>Vermont.</u>

A second major granite producing area is Barre, Vermont. There, about 30 granite companies supply both monumental and building granite, employ approximately 1,700 people, and have aggregate sales of between $50,000,000 and $70,000,000. All of the granite companies in Barre are family owned and operated and most of the companies have sales volumes of under $8,000,000, with a majority being in the $2,000,000 to $5,000,000 range, and many others have sales below $2,000,000. The dimension granite industry has been the mainstay of the Barre area's economy since the turn of the century. That industry, one of the largest employers in the State of Vermont, has an economic impact on the central Vermont area which is equal to that of the Elberton area on Georgia.

Minnesota.

A third major granite area is the area around Cold Spring, Minnesota. The largest dimension granite company in America in terms of total dollar sales is located there, as are six smaller granite companies. All of these companies are family owned and operated. Total employment in the dimension granite industry in that area is approximately 1 000 workers, with aggregate sales of between $60,000,000 and $80,000,000. The industry is a major employer in this portion of Minnesota; its overall impact is comparable to that of the Elberton and Barre granite-producing regions in their states.

Texas.

The fourth major area for granite quarrying and manufacturing is the state of Texas. There are two granite companies in the Marble Falls and Raymond, Texas, areas. These companies, both of which are in the building granite industry (which is the hardest hit by imports) employ 450 to 500 people and have combined sales estimated to be between $30,000,000 and $50,000,000. The economic impact of repeal of percentage depletion for granite would clearly be significant here, as well.

There are other areas where major impacts from the repeal of the granite depletion allowance would occur, including South Dakota, North Carolina, New Hampshire and Massachusetts. In each and every one of the above areas, the tax axe created by repeal of percentage depletion for granite will fall on small, closely held family companies and their employees--taxpayers who have the least ability to adjust to dramatic changes in their economic circumstances--and would be crippling to the economies within these areas. In short, what the Administration's proposal would create is the very real risk of pockets of severe economic dislocation with high unemployment--conditions comparable to the Depression.

Conclusion.

It is critical to our industry for this Committee to understand that repeal of the depletion allowance for granite would put an entire segment of the small business community at substantial risk of survival. This is not, I am sure, the Administration's intent nor is it the intent of the Congress. The Chairman of this Committee has wisely decided that hearings on the Adminstration's proposals must be extensive, and that statements from those unable to appear be solicited, so that all taxpayers will have a true chance to voice their views on problems regarding this tax reform proposal. The other side of the coin, and the really important one, is that by this process the members of the Senate Finance Committee will learn what the actual effect of the Administration's generalized and somewhat theoretical "reform" measures will be in the business lives of so many sectors of the Nation's economy from which this Committee does not usually hear.

The ramifications from the Administration's proposals are immense and all of them must be analyzed before a step is taken in the name of simplification which will have the result of destroying an industry. As a capital-intensive "smokestack" industry, the granite industry would be among those most severely affected by other portions of the Administration's proposal. Abolishing the investment tax credit and changing depreciation schedules would hit our industry and other heavy industries very hard. The service and financial industries, in contrast, would achieve significant tax savings from the Administration's proposal. If the granite depletion allowance is repealed, the members of our industry simply want Congress to know that such action will put an entire segment of the small business community on the brink of collapse.

We know that both Congress and the President want to enact a fair and equitable tax system. But fairness and equity are not achieved by driving small businesses into bankruptcy and devastating the economies of whole areas. Individuals are not benefitted by measures that alleviate their income tax burden by relieving them of jobs.

The Administration carved out an exception for so-called stripper wells because without the depletion allowance they would become unprofitable and in many cases would be abandoned--to the Nation's detriment. Fairness and the Nation's welfare require that the dimension granite industry's depletion allowance be retained as well.

Kurt M. Swenson
President
National Building Granite
Quarries Association
Box 482
Barre, Vermont 05641

(802) 476-3115

Submitted on behalf of:
National Building Granite Quarries Association
The Barre Granite Association
The John Swenson Company, Inc.
Rock of Ages Corporation

TESTIMONY OF

THORNTON STEARNS

TAX POLICY SUBCOMMITTEE CHAIRMAN

AND

ROBERT L. HADDAD, C.P.A.

TAX COMMITTEE CHAIRMAN

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND (SBANE)

WALTHAM, MASSACHUSETTS

BEFORE

SENATE FINANCE COMMITTEE

CONCERNING

TAX SIMPLIFICATION AND REFORM

JULY 10, 1985

TESTIMONY
PART I

I. Introduction

My name is Bob Haddad. I am a Small Business Tax Partner at Price Waterhouse in Boston. I am also Chairman of the Tax Committee and a Director of the Smaller Business Association of New England. (SBANE)

This is Thornton Stearns. Mr. Stearns is President of Vacuum Barrier Corporation located in Woburn, Massachusetts. Vacuum Barrier Corporation is a small manufacturing firm employing forty individuals. He is also Chairman of the SBANE Tax Policy Subcommittee. Mr. Stearns will share with you his insiders view of the impact of tax reform on small business.

Our committee has been very active in recent years with regard to various tax issues affecting small business. The Tax Committee has played a strong role in the establishment of SBANE as an influential voice of small business.

The Committee's activities are varied. Among other endeavors, the Committee organizes meetings with Congressional representatives, analyzes and evaluates proposed legislation and members often testify with regard to the impact of the proposed legislation upon small business. Today we have been called before the Senate Small Business Committee to testify concerning the impact of the major tax reform and simplification proposals on the small businesses of New England.

II. Summary Statement

The Smaller Business Association of New England does not feel that there is anything inherently wrong with the simplification and reform of our current tax system. In fact, SBANE strongly endorses simplification and the uniform application of equitable tax law over a sustained period of time. However, SBANE cannot support any tax reform proposal that inequitably shifts the burdens of taxation on small business.

SBANE believes that prior to the implementation of any tax reform alternative a careful and in depth analysis of such alternative's impact on small business must be undertaken. This comprehensive analysis must include an evaluation of the increase in tax burden relative to big business along with a study of the inordinate payroll tax burdens synonomous with small business ventures. Also, it is imperative, due to the inequitable access to capital that plagues small business, that any such tax reform proposal be thoroughly scrutinized as to its impact on small businesses' ability to generate investment capital.

III. Review of Current Reform Proposals

In recent months our tax committee has reviewed and extensively analyzed the major alternative tax system proposals to be discussed today: namely, the Bradley-Gephardt Fair Tax proposal, the Kemp-Kasten Fast Tax proposal, the initial Treasury

Tax Reform proposal and the recently released Administration proposal. Our findings are summarized as follows:

A. Lower Marginal Rates

Unincorporated Small Businesses - The proposed decrease in marginal rates is very attractive to owners of unincorporated businesses such as sole proprietorships or partnerships. The Treasury has estimated that 78% of all individual taxpayers would experience a reduction in tax. Thus, the reduced rates, should enable unincorporated small businesses to retain more internally generated capital.

Incorporated Small Businesses - Institution of a flat corporate rate somewhere in the low thirty percent range would have a disproportionate impact upon incorporated small businesses having less than $100,000 in taxable income in a given year. Due to the proposed repeal of the graduated corporate income tax for earnings of less than $100,000, marginal rates for these corporations would be sharply increased. Even a corporation with taxable income of $100,000 will face a 28% increase in its effective tax. These smaller corporations represent 90% of all U.S. corporations, or about two million incorporated entities. A recent study initiated by a national public accounting firm concludes that for the five year period 1986-1990, the lowering of the marginal rates provided by the initial Treasury proposal which eliminated the graduated rates would increase the tax for those corporations with taxable income of $100,000 or less by $31 billion while higher earning corporations would enjoy a $204 billion reduction.

SBANE believes that all reform proposals involving rate change must maintain some form of graduated scale so as not to disproportionately increase the tax burden of smaller businesses. SBANE strongly supports the inclusion of such graduated rates in the recently released President's tax reform package.

B. Industrial Development Bonds

Elimination of "private purpose bonds", also known as industrial revenue bonds or industrial development bonds is incorporated into almost all alternative tax proposals. The debate on industrial development bonds (IDB's) has endured many years. The proposals to eliminate private purpose IDB's are a classic example of the lack of our government's clearly defined national policy. A study recently prepared by a national CPA firm for the Massachusetts Industrial Finance Agency concluded that almost 70% of the companies receiving IDB financing had fewer than 200 employees and sales of less than $20 million. Almost 50% of this financing went to firms with sales of between $1 and $5 million. Note that the famous "Birch" study at MIT identified this size company, both incorporated and unincorporated, as generating over 50% of the new jobs created nationwide. The firms responding to the Massachusetts survey had an average growth in jobs of 24% after receiving the favorable financing; whereas the Massachusetts statewide manufacturer employment rate decreased by nearly 1%. My own experience has been that the vast majority of small businesses could not have added manufacturing, warehousing and distribution facilities if it were not for the availability of long-term money at reasonable interest rates through IDB's. These funds are the cornerstone of small business growth. Where can smaller business turn if this source is eliminated?

SBANE supports retention of industrial development bond financing as a much needed source of capital for small business growth. SBANE does, however, recognize the margin for abuse involving current IDB financing. As a result, SBANE proposes a gross receipts cap limiting the benefit of IDB's to smaller businesses. Also, a cap could be instituted limiting the amount of IDB's available to a particular business within a certain time span.

C. Capital Gains Rates

The Bradley-Gephardt proposal would tax long term capital gains as ordinary income as did the initial Treasury proposal. The Kemp-Kasten proposal significantly reduces the rate benefits applicable to capital gains. The Administration's proposal maintains and, in fact, increases the rate benefit applicable to long term capital gains.

Any reduction in preferential rates for capital gains will have a significant detrimental effect on investment in small businesses. Capital formation is a very serious problem for small businesses. Small businesses have a very restricted access to cash through normal channels - at reasonable rates. Preferential rates for capital gains represent a reward for placing capital at high risk and are, thus, a critical element in the capital formation of these small businesses.

In order to promote investment in small businesses and assist in providing access to capital, SBANE supports the maintenance of a clear differential between the tax rates applied to capital gains and those applied to ordinary income.

D. <u>Research & Experimentation Credits</u>

Excluding the President's tax reform plan, tax reform proposals have generally mandated the elimination of the tax credit for increased research and experimentation expenditures.

The credit for increased research and experimentation expenditures is intended to act as an incentive for technological innovation. The credit is intended to serve as a reward for those who place their capital at risk in developing new and innovative technology. Small business is the major source of technological innovation in our economy. The credit allows small businesses to retain more of its internally generated capital. As such, it is an instrumental element of the capital formation of small business. The importance of the credit to small businesses in New England was recently documented in a joint study undertaken by SBANE and the national public accounting firm of Ernst & Whinney. (The study is attached as Exhibit I).

SBANE strongly supports the retention of the research and experimentation credit in the President's tax reform proposal. SBANE believes that this credit plays a major role in the economic vitality of our country.

E. Fringe Benefits

Elimination of the current exclusion from gross income of at least some employer provided fringe benefits is proposed by all of the alternative tax proposals. For example, the President's proposal would limit the exclusion available on employer provided health insurance. Those benefits which would be subjected to taxation under at least one of the alternative tax plans include group term life insurance, the special treatment of cafeteria plans, educational assistance programs, legal services and dependent care.

Although the above changes will adversely affect all businesses, the impact will be more burdensome on small business because of its inherent competitive disadvantage. Small businesses do not stand on an equal footing with large businesses in their ability to provide fringe benefits. Lack of sufficient profitability is the major obstacle preventing small businesses from offering more generous employee benefits. However, the ability of small business to offer employees a somewhat competitive package of compensation remains an important factor in their ability to compete with larger firms.

Most owners of closely held companies feel an obligation to their employees which is markedly different than that which exists in big businesses. I have been told by several owners that if such fringes were taxed, the owners would pay their employees increased compensation so as to leave them "whole" on an after tax basis. This, of course, would increase significantly the cost of operating these small businesses.

As part of an overall reform proposal, SBANE supports the introduction of a threshold size, such as gross receipts of 10 million or less, wherein present fringe benefit exclusions would be retained. However, it should be noted that we are extremely concerned that any taxation of fringe benefits might open the door to further taxation of such benefits in the future. The reason for this concern relates to recent payroll tax history as discussed below.

F. Payroll Taxes

Small businesses are very concerned about skyrocketing payroll costs. Small firms are, generally, labor intensive and a larger portion of their payroll is subject to these taxes. Payroll taxes are normally levied at a flat rate up to a maximum amount of annual taxable earnings. Therefore, these taxes are regressive throughout the income scale. In addition, this increasing tax burden inhibits the growth of labor intensive businesses because the cost of operations rises at a faster rate than in capital intensive businesses.

In an informal survey released by Price Waterhouse, attached as Exhibit II, smaller businesses were asked to rank public policy issues. Ninety six percent of the respondents in New England said that payroll taxes were their number one concern. According to a report from the Small Business National Issues Conference, nine Social Security rate increases totalling 60%, nine Social Security base increases totalling an estimated 677%, three federal unemployment (FUTA) rate increases totalling 94% and three FUTA base increases totalling 133% have occurred or are scheduled between 1970 and 1990.

The SBA has substantiated the fact that the payroll tax burden for small businesses is almost twice as large as the income tax burden. Accordingly, the small business community believes that payroll taxes must become a part of the broad tax policy debate. Despite the immediate as well as long-term problems of funding Medicare, Social Security, and unemployment, Congress must be convinced that the small business community can no longer support a continuing spiral of payroll taxes.

IV. Other Reform Proposals

A. Minimum Tax - The continuing decline in the share of taxes paid by corporations, the large deficits and the substantial notoriety concerning high profit businesses that pay little or no taxes are factors which have caused a number of members of Congress to support proposals to institute new or tighter minimum taxes. All of the proposals employ an alternative minimum tax approach which is similar to the existing alternative minimum tax with respect to individuals. That is, each adds to taxable income an amount equal to the tax preferences as defined by the proposal and reduces such amount by an exemption allowance. This amount is multiplied by a flat rate and the resulting figure represents the minimum amount of tax payable by the corporation.

SBANE recognizes the need for corporations to remit their fair share of taxes to the government. However, depending upon the exemption amount and the rate applied, this minimum tax could be used as a vehicle to increase the taxes paid by those corporations with taxable income of less than $100,000. That is, those corporations currently benefiting from the graduated rates below $100,000 in taxable income. Therefore, SBANE supports the institution of an exemption amount and a rate which will guarantee the preservation of the surtax benefit.

B. Value Added Tax - Discussions concerning the institution of a value added tax system have been ongoing for a number of years. The VAT is an indirect tax that is imposed on each sale beginning with production and culminating with sale to the ultimate consumer. The tax is applied at a flat rate much like a sales tax, however, the rate is generally much higher. The ultimate goal of the system, after offsetting VAT previously paid by sellers, is to impose a tax at each stage of production on the sum of wages, interest, rents, profits, and other factors of production not furnished by suppliers and previously subjected to the tax at an earlier stage of production. That is, a value added tax.

The recent survey of the members of the Smaller Business Association of New England and other regional executives, undertaken jointly by Ernst & Whinney and SBANE, indicated that, among companies with ten or fewer employees, 79% of the respondents oppose institution of a VAT system (See Exhibit I). In fact, 71% of the total respondents, whether representing big business or small business, oppose a value added tax.

SBANE opposes institution of such a VAT system. This system would be inordinately difficult to administer no matter what the size of the venture. Such an administrative burden would, however, obviously have a disproportionately negative impact on small businesses with fewer employees, less specialized expertise and less capital.

V. Assessment of Economic Impact of Proposals

As previously mentioned, the small business community cannot overemphasize the need for an intensive economic analysis to be performed measuring the impact of various reform proposals on all segments of our economy. The elimination of numerous tax credits and deductions which businesses have relied upon and planned within for many years is no small task. SBANE must be assured that intensive research will be performed analyzing the impact of proposed tax reform legislation on the economic vitality of all segments of our society. The research underlying the current proposals appears to be somewhat less than comprehensive. For example, the initial Treasury proposal did not fully assess the impact of the plan upon small business. This was evidenced by the elmination of both the graduated rates and the preferential capital gains rate. The President's proposal to limit the deductibility of business meals and eliminate the deductibility of entertainment expenses has a potentially devasting impact on numerous small businesses. This also appears to have been overlooked in the drafting of the President's proposal which only speaks to the purported abuses and not the potential impact on small businesses..

VI. Alternative Tax Proposals - Impact on New England

New England possesses a unique economic climate. It is an area of relatively low unemployment, documented business growth and continuing start-ups. Small business has and will be a major force in this economic vitality. The joint study on small business previously mentioned, indicated that a slight majority of the small businessmen responding oppose a new business tax system that would reduce the top corporate rate and eliminate many business deductions and credits.

It appears that this less than enthusiastic response to tax reform is based primarily on a concern with regard to any new system's incentives for capital formation. Small businessmen continuously rate as their top concern, regarding an alternative tax system, its ability to stimulate capital formation. Items stimulating such capital formation include the research and development credit, preferential rates for capital gains, jobs credits, the investment tax credit, industrial development bonds and SBA guaranteed loans. One might postulate that an alternative tax system that adequately addresses the capital formation concerns of small business would be supported.

VII. Conclusion

The Smaller Business Association of New England and the small business community feel that tax simplification and reform in effort to make our system more efficient and equitable would be beneficial to our economy and society. However, in formulating such alternative system, the incentives and stimuli that have made small business the cornerstone of economic vitality in New England and in the United States cannot merely be ignored. Prior to the enactment of any tax reform package, ardent and intensive research and studies must be conducted to determine the impact on the future of small business. To date, such analyses have only touched the surface with respect to the impact of various proposals on small business.

Finally, we would like to state that the President's recent proposal includes consideration of a number of the concerns that we have raised. Accordingly, we feel that it is appropriate to support the concepts embodied in that proposal, however, we do believe that a great deal of "impact analysis" needs to be performed.

TESTIMONY
PART II

I. Introduction

My name is Thornton Stearns. I am the President of Vacuum Barrier Corporation of Woburn, Massachusetts which is a manufacturer of vacuum insulated cryogenic piping systems. I am also a Director of the Smaller Business Association of New England, a member of the Tax Committee, and Chairman of the Tax Policy Subcommittee.

Mr. Haddad's testimony presents the official position of SBANE. My testimony will be presented as the Chief Executive Officer of a small manufacturing business.

II. Summary Statement

The strength of the small business community is critical to the economic development of our nation. Yet, small businesses face a constant challenge with respect to the availability of capital. Small businesses simply do not have sufficient access to capital. As a small businessman, I feel that any credible tax reform proposal must simultaneously address this serious problem.

III. Overview

According to data in Statistical Abstracts, Federal, State and Local government spending represented approximately 37.5% of the gross national product in 1981. This percentage has more than likely increased since the time of the study. This represents an intolerable burden on our society. The reduction of federal expenditures and the passage of the proposed tax simplification and rate reduction of both personal and business taxes go hand-in-hand in the necessary and desirable effort to free the creative and productive sectors of our economy.

Tax reform and the reduction of Federal expenditures require corrections of a social and economic nature which will have profound effects on large segments of our economy. The Administration and Congress are now reviewing the various options and actions which will allow the corrective actions to be taken in areas and at rates which can be absorbed by our economy.

I would direct your attention to and urge your consideration of the correction of the bias <u>against</u> private capital.

IV. <u>Small Business and Private Capital</u>

Studies have shown that small business is responsible for nearly all of the job growth of our economy as well as a large part of the development of new ideas and products. The need for private capital exists primarily in manufacturing small businesses. Between $50,000 and $100,000 of capital is required per employee. The startling catalytic effect of this investment of capital can be revealed by putting it in the tax perspective. With good management and a little bit of luck the $100,000 invest ment can employ a person for a lifetime. Including corporate and individual tax payments, the government can receive hundreds of thousands of dollars in taxes as a result of this investment.

A survey of SBANE members indicated the source of founding capital to be as follows:

Family business	20%
Owners savings	60%
Outside private individuals	13%
Investment corporations	0%
Other	7%

Over 90% used private capital to establish their new business.

Bank credit can be obtained as part of the initital start-up capital, but only if sufficient equity capital exists. Even the useful SBA guaranteed loans, which allow less equity capital, must be guaranteed by personal endorsements.

After the business is established, other sources of capital are used as follows:

Internally generated	70%
Bank loans	50%
Investment corporations	20%
Outside individuals	27%

Outside private capital is still required. Twenty seven percent of the companies use it as a source of growth financing.

Therefore it can be seen that private capital is a critical ingredient to the formation and growth of small manufacturing companies. Yet there are a number of taxes which are specifically directed against private capital.

V. Effect of Taxes on Private Capital

I will now review the major taxes and their effect on the formation of private capital.

A. General

All of the new tax proposals - the President's, the Bradley-Gephart proposal, and the Kemp-Kasten proposal - reduce the top marginal tax rates on both individual and business taxes. This will be beneficial in that it will increase the availability of private individual capital and business capital which is internally generated.

B. Double Taxation of Dividends

The trend in the Administration's two proposals is unfortunate, since the initial Treasury proposal exempted 50% of dividends from corporate taxation, while the President's proposal exempts only 10%. This double taxation has the disadvantage of discouraging equity capital while encouraging borrowed capital. We in business are aware of the disastrous effects of the cost of servicing fixed debt. The Federal

Government is becoming painfully aware of the same effect, now that the payment of interest on debt is a major portion of the deficit. A striking 80% of small businesses surveyed favored the elimination of the double taxation of dividends.

C. Capital Gains Tax

This tax impacts very heavily the initial and growth equity financing of small businesses since the money obtained by selling previous investments is reduced by the capital gains tax. This is very critical since the entrepreneur is trying to scrape up every penny possible to launch his new venture. Seventy percent of the small businessmen surveyed approved modification of the capital gains tax. Half of those surveyed favored a reduction of rates, while the other half favored elimination.

D. Estate and Gift Tax

The Estate and Gift Tax is not a huge revenue raiser for the government. It amounts to only one or two percent of the annual revenues. However, the catalytic effect of the reduction of capital is the converse of the positive effect referred to above. The removal of 50 to 100 thousand dollars of equity eliminates a job and the long term employment of one person along with the loss of hundreds of thousands of dollars of tax revenue.

Furthermore, in a large number of cases, the death of a major owner may force an independent small business to be sold to a larger corporation in order to raise the cash required to pay estate taxes within the year's limit. About 75% of small businessmen surveyed favored modification of the estate and gift taxes as follows:

Increase exemption	32%
Decrease rates	24%
Eliminate	20%
Increase rates	1%
Decrease exemption	7%

Unfortunately, reduction of estate and gift taxes is not part of any of the present tax reform proposals. It would appear appropriate to reduce the maximum transfer tax to a rate equal to the maximum individual tax rate.

VI. Conclusion

There is a critical need for private capital for the formation and growth of small businesses. The growth of employment in our country is dependent on small businesses. I hope that Congress, in the difficult task of developing the priorities and actions for tax reform, will consider the catalytic effect of private capital, and will reduce or eliminate those taxes which specifically tax capital.

The exhibits are in the official Committee files.

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