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TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED FRIDAY, OCTOBER 3, 1969

PART B—ADDITIONAL STATEMENTS

(Topics: General; Tax Treatment of Physically Handicapped; Tax Treatment of Treble Damages; Foreign Tax Credit)

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

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TESTIMONY ON ALL TAX BILLS INTRODUCED

by SENATOR TED STEVENS

October 2, 1969

Thank you for giving me this opportunity to testify before this committee on behalf of this important tax legislation.

There has been a great outcry from the American people for tax reform. If there is any one common element of tax reform which is a consistent part of this cry, it is for greater equality in the distribution of the tax burden. The House bill, while containing several excellent provisions toward this goal, leaves several important inequities untouched. I have introduced several bills which would help to correct these deficiencies.

The first bill I would like to call to this committee's attention is S. 1908. This bill has two main purposes. The first would raise the personal exemption from its present $600 level to $1,000. Personal exemptions benefit, primarily, the poor and middle income tax paying families, and these families are, in my opinion, the most heavily burdened by our present income tax. In 1913, when the income tax became a permanent part of our economic fabric, the dollar was worth far more than it is today, but the personal exemption was $3,000 and was never less than $1,000 until 1940. It was then gradually reduced during the years of World War II to $500. It was last increased in 1948--when a dollar was worth more than twice what it is today--to its present $600 level. In other words, in terms of today's dollars, the personal exemption of 1948 was worth over $1,200. Thus, the first purpose of S. 1908 would help to restore the balance in our graduated tax system that inflation has destroyed.

The second purpose was to help to correct a long-standing inequity in the income tax. This provides for an increase in the personal exemption in those areas of the country where the cost of living exceeds the national index. In some regions of our country the cost of living is 10, 20, even 50% higher than the national index. It is 8% higher in San Francisco, 11% higher in New York

City, 22% in Honolulu, and 43% in Fairbanks. Obviously, if the graduated income tax is to affect persons of equal standards of living equally, the differences in the cost of maintaining that standard of living must be taken into account. S. 1908 would help to correct this inequity.

I would now like to draw this committee's attention to three bills, S. 1047, S. 2739, and S. 2760, which would allow certain expenses of taxpayers to be deductible. The first of these bills would allow for the deduction of funeral and burial expenses, in the same way medical expenses in excess of 3% of adjusted gross income are presently handled. The costs of medical care are spiraling upward, and the costs of major illnesses are truly devastating. These excessive medical costs are deductible, and rightly so. But, should the illness prove to be terminal, the costs of final disposition of the deceased are not deductible. I believe these expenses should be viewed as terminal medical expenses. My bill would correct this deficiency. To assure that this deduction does not promote more expensive funerals, it specifically excludes cemetary plots and memorials from the category of deductible expenses and limits the deduction to $2,500.

The second bill, S. 2937, would enlarge the class of expenses that may be deducted as legitimate moving expenses to include reasonable expenses for traveling to search for a new residence, for meals and lodging while in temporary quarters waiting to move into a new permanent residence, and expenses incident to the sale of the taxpayer's former residence or resolution of his lease and incident to the purchase of a new residence. The total deduction for moving expenses would be limited to $2,500. In those situations in which a taxpayer is not reimbursed by his employer for moving expenses, the costs described above represent a real hardship to the transferred employee. And, if his employer does choose to reimburse him for such expenses, he must report such reimbursement as ordinary income even though he was required to make such expenditure in order to retain his job. This is obviously an unjust situation and S. 2739 would correct it.

The third bill, S. 2760, would remove the restriction which presently limits deductions for care of dependents of working mothers to taxpayers whose combined husband-and-wife earnings are less than $6,500. The present limit was designed to assure that the benefit would be available only to those families in which the mother was required to work in order to support the family. Unfortunately, a flat limit cannot accomplish this end fairly, for it clearly gravitates against larger families or families living in areas having excessive costs of living. I, therefore, favor removal of the limit so that all working mothers may enjoy this benefit equally. S. 2760 would accomplish this.

I would now like to discuss another inequity in the present tax law which S. 2736 is designed to correct. Employees under qualifying plans ard self-employed persons may have part of their salary placed in a fund and not have to pay tax on this money, nor on the earnings of such a fund, until the money is distributed. But the employee whose employer does not offer a qualified plan cannot take advantage of this tax benefit. S. 2736 would allow such an employee to be treated as a self-employed person, and thus eliminate this inequity.

H.R. 13270 also dealt with the tax treatment of lump sum distributions of these retirement funds. The presumed purpose of denying capital gains treatment to these distributions was to prevent the receipt of substantial amounts of deferred income at capital gains rates. But I would like to point out to this committee that, under H.R. 13270 as passed b the House, a person who has had his employer contribute $25 a month for the past twenty years will be affected to a far greater extent than a person who has had $1,000 per month set aside for the previous five years. Assuming our first employee was living only on social security at the time of the distribution, he would pay a tax of $500 under present rules and $885 under the provisions of H.R. 13270. This is more than a 75% increase in taxes. The second hypothetical employee would pay $11,150 under the present system and $14,150 under the House bill. This is less than a 30% increase in taxes. A person receiving a very large distribution, say $1,000,000, would indeed be required

to pay nearly 150% increase in taxes.

I suggest we allow every taxpayer to receive a limited amount of money as a lump sum distribution tax free and require everything over that amount to be taxed as ordinary income. This would continue the incentive to create retire benefit and profit sharing programs. The average lump sum distribution made in 1968 by Sears, Roebuck and Co., which has one of the nation's oldest profit sharing plans, was reported to the House Ways and Means Committee as being slightly over $100,000. I suggest that an exemption of $50,000 would be appropriate, since this would leave the average distribution in precisely the same position it is in today. I urge this committee to consider this proposal. If the incentive for private retirement plans is to continue to perform the function for which it was designed, it should not be eroded in the way H.R. 13270 proposes.

I have also offered several amendments to H.R. 12290, which, taken in the aggregate, will do the following: They will continue the benefits of the 7% tax credit for investments in depressed areas, for small business property and for intrastate pipeline property. A depressed area, under my amendment #102, is defined as a state or political subdivision with an unemployment rate of 6% or more for the calendar year. During the last 12 years, my state has experienced chronic unemployment ranging from a low of 8.0% to a high of 10.3% and, in fact, experiences unemployment in excess of 80% in certain remote villages. By retaining the credit for investment in depressed areas, the employment balance in America could be dramatically improved and chronic unemployment in certain areas of this country could be ended by stimulating private enterprise. If we are to deal directly with unemployment, the costs will be staggering. I prefer to continue the incentive to provide new jobs. The provisions involving small business and intrastate pipelines would also be of assistance in helping to end this unemployment problem.

Finally, I would like to point out an inequity in procedures that presently exists in IRS practices. When the IRS files a lien on real property for non-payment of income taxes,

that lien is duly recorded. When the taxes are paid, the IRS notifies the property owner that his slate is clean, but it is not required, nor does it in practice notify the county or borough recorder to remove the lien. When the taxpayer sells his property, the purchaser will discover the lien and will usually end up bearing the cost of removing the lien in order to obtain title insurance. Any other person placing a lien on property would be required to remove it, but the IRS is not. There is no reason why the IRS should enjoy this special advantage nor, according to its own policies, should it enjoy this privilege. My bill, S. 2879, would require the IRS to notify the place at which the lien was originally recorded that it has been satisfied.

I would now like to draw the attentions of this committee to the provisions of H.R. 13270 that would reduce the depletion allowance for oil and gas from 27 1/2% to 20% and would require the intangible drilling expenses for these industries to be capitalized rather than expensed.

Mr. Chairman, as everyone is now well aware, large oil discoveries have been made in the forbidding Arctic regions of my state. The discovery is of such a magnitude that it is expected to increase the proved oil reserves of this country significantly. But the costs of exploration that led to this great discovery were far greater than any previous exploration. The costs of developing these reserves will be far greater than the costs of developing previous discoveries, and the cost of transporting this oil to domestic markets is significant. If it had not been for the incentives--and that is what the existing tax provisions are: incentives, not loopholes--exploration in the Arctic regions probably would not have taken place, and our great reserves might be unknown today. These reserves are now ready to be developed, but the costs of this development are staggering. The pipeline which will carry the oil from Prudhoe Bay to Valdez on the Gulf of Alaska will cost an estimated $900 million; each well will cost an estimated $1.2 million compared with an average of $50,000 for previously drilled wells. This is a tremendous capital investment. Where will the money for such investments come from?

For the most part, it will come from the recovery of capital invested in earlier oil fields. How is this money recovered? It is recovered, previously, through the depletion allowance. That allowance assures that the oil industry will retain enough capital to continue exploration and development programs. If this allowance is reduced, it will have significant effects on the future growth of the oil industry.

The investment made so far in exploring for oil in Alaska is estimated at $1.3 billion. That investment was made on the assumption that the incentives contained in the depletion allowance and the expensing of intangibles, which originally encouraged the oil industry to attempt the development of Alaska's petroleum, would be continued. Now this committee is considering a bill which would, in effect, tell these companies who have committed themselves to investing a great amount of money in Alaska that these incentives, which would have provided the capital for the continued development of Alaska's oil reserves, are to be significantly reduced and that these companies will have to look elsewhere for needed capital. Where else, today, can they look?

But this bill goes further than that. It tells the people of Alaska that the incentives which helped to develop the oil reserves of Pennsylvania, Wyoming, Texas, California, Oklahoma, and the other oilproducing states are to be denied Alaska. If these incentives are reduced, Alaska must face the fact that she will be denied the benefits that spurred the development of other states; that Alaska's hopes for the future, which have risen so high with the September 10 lease sale, are now to be dashed on the rocks below.

The Alaska Department of Natural Resources has studied the effects the proposed reduction in the depletion allowance and the elimination of the provision allowing the expensing of intangible drilling costs on my state. The annual loss of income to the State of Alaska--from such sources as leases, royalties, and taxes on the oil and related support industries--that would result from the passage of H.R. 13270 would be approximately $100 million--more than half the entire state budget for fiscal 1969. And this takes into account only the loss on proven oil fields. It does not even contemplate the effects of discontinuance of exploration in several

other promising areas that will probably result if these incentives are reduced.

Aside from the gross unfairness to one state that will result if H.R. 13270 is passed, this committee should consider the effects on the economy and particularly on the consumer that result from this legislation. Already the oil industry is preparing to build the $900 million Trans-Alaska Pipeline; it has authorized the construction of three new tankers larger than any ship yet built in American shipyards and is considering building a fleet of tankers twice that size to sail the Northwest Passage; it is planning to build airfields, refineries, and dozens of other support facilities. The effects on the construction industry, the shipbuilding industry, the steel industry, and dozens of other industries involved in this development will be drastic if the capital for these projects is severely curtailed, as it most certainly will be if H.R. 13270 is passed. The oil industry is hardly the exclusive beneficiary of these incentives; they benefit all of America.

And what of the consumer I mentioned earlier. In the end, he will bear the burden of the reduction of these incentives, as he does all tax increases. The discovery of oil in Alaska has been made just at a time when rising consumption was exceeding discoveries of new reserves. As those reserves were gradually exhausted, the price of a gallon of gasoline would have risen significantly. Gasoline is one of those rare items which, taking inflation into account, costs less today than it did 20 years ago. In 1949 the average cost of a gallon of gasoline was 41.5¢ in terms of 1969 dollars, while today it is only 33.7¢. The development of Alaskan oil can continue this price stability, but, if the capital to develop these new fields is not available, Alaskan oil will not reach the marketplace in sufficient quantity to prevent the impending price rise.

Many critics of the depletion allowance are quick to point out that the allowance would only be reduced, not eliminated, by H.R. 13270. I must point out that the economic feasibility of the Alaskan oil fields, with the high cost of development in the

harsh Arctic environment, is dependent on the savings of large scale production made possible by the magnitude of the Prudhoe Bay discovery. The scale of development must be enormous if our oil is to be competitive. You cannot decide to build a $500 million pipeline instead of a $900 million one if it will be 300 miles short of the oil fields. You cannot settle for fewer tankers if the tankers cannot handle the full capacity of the pipeline. The point is, the industry needs all the capital the existing incentives will provide if any of the development in the Arctic is to make economic sense.

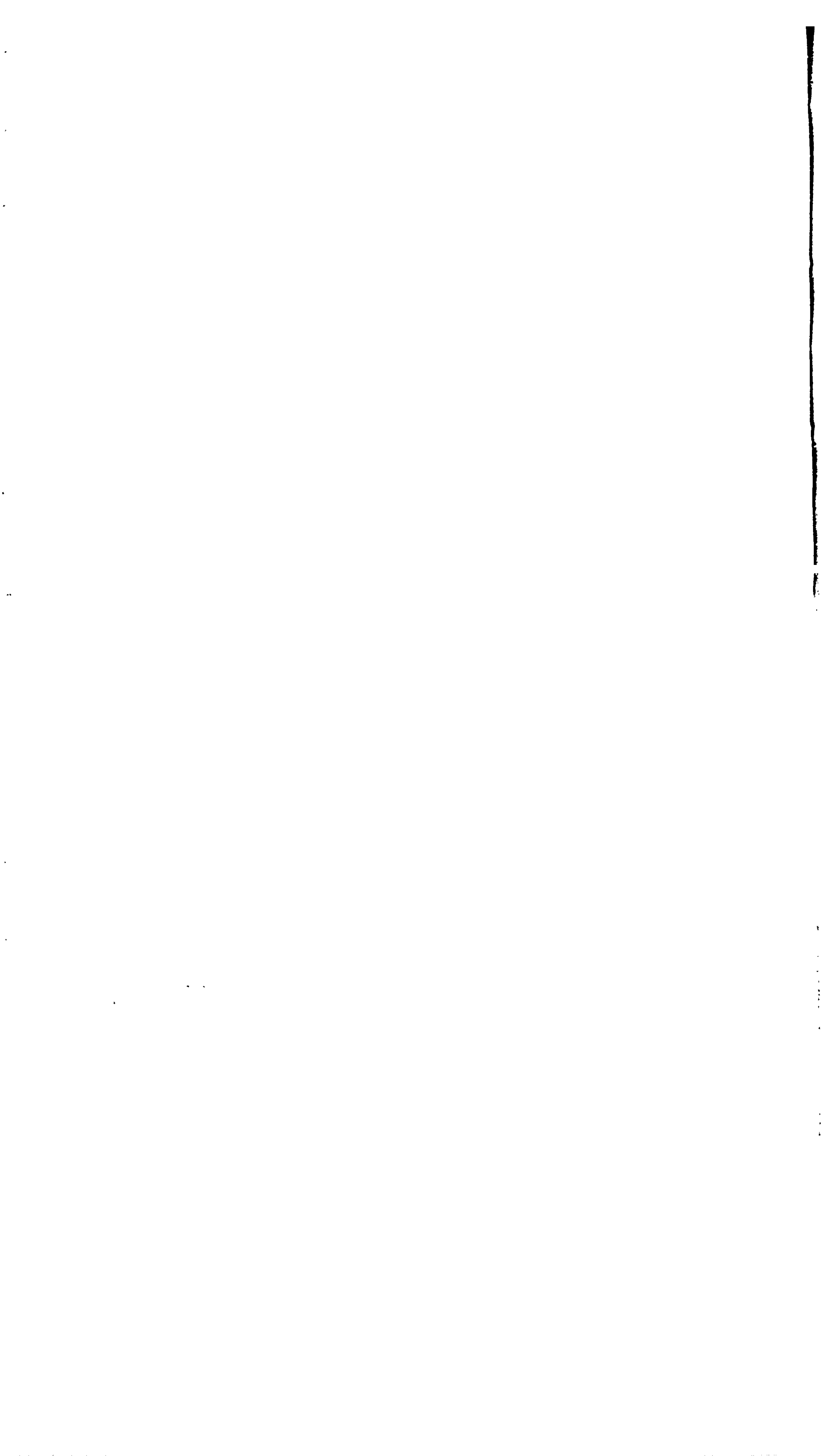
We are thus at a time, and I hope I have made this point clear, when the reduction of these incentives could do irreparable harm not only to Alaska, which will most certainly suffer severely if this legislation is passed, but also to the entire nation. I see no reason to deny the consumer of America the benefits of Alaskan oil in the name of tax reform. The oil industry is not even one of those industries escaping taxation. It pays a larger percentage of its gross revenues in taxes than does the average American business enterprise. And that does not take into consideration excise and sales taxes, which are three times greater for the oil industry than they are for the average American business. It pays less in federal corporate income taxes, it is true, but it pays much more in state and local taxes. At a time when the federal government is urging revenue sharing, this committee has before it legislation that would cause a greater share of the oil industry's tax dollar to flow into the federal treasury. And, if you think the federal treasury will gain by reducing those incentives, I would like to point out that the tax revenue from oil lying undeveloped in the ground 8,000 feet below the frozen Arctic is precisely nothing. Where is the tax saving in that?

The reduction of these incentives will have nothing but deleterious effects on the economy, the consumer, and the treasury, and contributes nothing to the goal of tax reform. I urge this committee to delete those provisions from H.R. 13270 and allow the oil industry to continue to utilize the incentives that brought them to Alaska so that it can stay there and benefit all Alaskans

and all Americans.

I would like, at this point, to request the committee's permission to offer at a later date testimony regarding those provisions of H.R. 13270 that affect the interest paid on municipal bonds.

Thank you for this opportunity to present my views to this committee on this important piece of legislation.



STATEMENT OF HONORABLE WRIGHT PATMAN (D-TEXAS),
CHAIRMAN, SUBCOMMITTEE ON FOUNDATIONS, HOUSE SELECT COMMITTEE
ON SMALL BUSINESS, BEFORE THE SENATE FINANCE COMMITTEE
ON TAX REFORM BILL, H. R. 13270
OCTOBER 3, 1969

PRINCIPAL POINTS

1. H. R. 13270 endorsed strongly. Requests that provisions affecting such organizations not be weakened.

2. Question raised why many privately controlled tax-exempt foundations are established.

3. 27 recommendations listed to deal with abuses uncovered by study of Subcommittee on Foundations.

4. Statistics cited indicating growth in economic power of foundations studied. Concern expressed for small business taxpayers who must compete with tax-exempt business.

5. Demonstrates that from 1951 - 1967 about 50 percent of foundation receipts were distributed for contributions, gifts and grants. Shows that expenses during this period ran $25 for every $100 in contributions, gifts and grants made; for 1967, $33 for every $100. Discounts statements that 7½ percent tax on net investment income will impair philanthropic activity.

6. Suggests more prudent business-like approach by foundations in their operations - reduce non-essential expenses, carefully review yield on stocks in portfolios and policies on contributions, gifts and grants.

7. Emphasizes there are many problems other than tax matters which require scrutiny - SEC, anti-trust, conflict of interest, etc.

8. Numerous deficiencies of Internal Revenue Service listed in administering and enforcing laws and regulations applicable to foundations.

9. Lack of public knowledge of foundation operations emphasized. Only 140 out of 30,000 publish annual reports.

10. Discusses H. R. 13725, Bill to establish independent Government Agency to control and supervise privately controlled tax-exempt foundations.

11. Efforts not directed to eliminating all foundations but to clearing up the bad apples in the barrel.

12. Declares that taxes in a democratic society should be shared equitably by all. Passage requested of H. R. 13270 as passed by the House and H. R. 13725.

STATEMENT OF HONORABLE WRIGHT PATMAN (D-TEXAS), CHAIRMAN, SUBCOMMITTEE ON FOUNDATIONS, HOUSE SELECT COMMITTEE ON SMALL BUSINESS, BEFORE THE SENATE FINANCE COMMITTEE ON TAX REFORM BILL, H. R. 13270
OCTOBER 3, 1969

Mr. Chairman, I greatly appreciate your invitation to testify before this Committee on H. R. 13270, the House-passed tax reform bill. I shall direct my remarks principally to the important subject of privately controlled tax-exempt foundations.

It has been puzzling to me for some time why the majority of privately controlled tax-exempt foundations were established in the first place. The religious, charitable and educational contributions which are made by foundations can just as well be made by an individual. The fact that the foundation route is taken, immediately gives rise to a question as to the actual purpose for establishing the foundation.

A great many huge family fortunes have been continued in perpetuity through the private foundation route. Controlling interests in closely held corporations have been transferred to foundations with no apparent change in the continuity of direction and control through this technique. I don't believe we really know the vast amount of tax dollars lost to this nation by tax avoidance through the vehicle of privately controlled tax-exempt foundations.

It appears to me that the time has come to look very closely at this problem, and to develop sufficient information so that the

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Congress can make a decision on the desirability of continuing the present concept of privately controlled tax-exempt foundations. Later on in my testimony, I shall speak further to this point.

At the outset, I would like to strongly endorse the provisions of H. R. 13270 dealing with privately controlled tax-exempt foundations. I hope this Committee takes no action to weaken the provisions affecting these organizations. This Bill is a step in the right direction and contains only the minimum reforms needed as shown by the experience of the Subcommittee on Foundations in dealing with this problem.

The Subcommittee on Foundations has been conducting a continuous and in depth review of the activities of privately controlled tax-exempt foundations for a number of years. During this period, seven reports were issued and two hearings were held. As a result of our study, a number of abuses of the tax-exempt privilege were uncovered and recommendations were made to deal with them. Although these recommendations have heretofore been made public, I believe it important that they again be made a part of the record.

1. In my view, consideration should be given to a limitation of 25 years on the life of foundations instead of permitting them to exist in perpetuity.
2. Tax-exempt foundations should be prohibited from engaging in business directly or indirectly.

Foundations controlling corporations engaged in business, through the extent of stockownership in those corporations, should themselves be deemed to be engaged in that business.

3. Commercial money lending and borrowing by foundations should be banned.

4. Self-dealing transactions should be prohibited. A foundation should not be permitted to use its funds to grant benefits to a controlled company's employees. This is quite a competitive advantage.

5. Foundation or donor solicitation or acceptance of contributions from suppliers or users of goods or services should be prohibited.

6. A foundation should not be in the position of exercising control over any corporation, directly or indirectly. In my view, all foundations should be limited to ownership of no more than three percent of the stock of a corporation and should not be allowed to vote such stock.

7. Standards should be established with respect to foundation behavior in a proxy fight.

8. Another area that needs consideration is that of investments. There is a sharp difference between investing in securities

and speculating or trading in securities. In other words, there is a difference between being a passive investor and an active securities merchant or gambler.

9. Is the tax law sound in permitting a deduction for charity to a person who merely transfers funds to a foundation that he himself controls, where the money has not as yet reached actual operating charities?

In my view, a contributor should not be allowed a deduction for payments to a foundation that he controls until the foundation actually uses the money for charity. The foundation should be recognized as being the alter ego of the controlling contributor. Income earned by the foundation should be taxable to the controlling contributor until put to charitable use.

10. Exemption should be denied if a foundation has been formed or availed of for tax avoidance purposes or to get financial benefits for the contributor. Conversely, a controlled corporation should not be allowed a contribution to a foundation, but instead the payment should be considered as a dividend to the controlling stockholder where the amount is significant and the foundation is unrelated to the business purpose of the corporation.

The tax law says that a foundation's earnings may not inure to the benefit of any private individual. It should be made clear that "individual" includes corporations and trusts.

11. Isn't there something out of gear with the tax law that, under the guise of charity, permits a taxpayer to actually enrich himself at the cost of all other taxpayers? One answer may be to treat gifts to foundations in the same way as private gifts, and figure them at the cost of the property given or their value, whichever is lower.

12. In the case of corporations that are treated like partnerships (Subchapter S, Chapter 1, Internal Revenue Code) contributions to foundations should "pass through" to the stockholders and be included pro rata as contributions by the stockholders personally. In that way, the 20 percent and 30 percent limitations on contributions will be maintained. At present, through the mechanics of Subchapter S (Chapter 1, Internal Revenue Code), an extra 5 percent of the corporation's income becomes deductible by the stockholders.

13. For the purpose of figuring the accumulation of income, contributions to a foundation and all capital gains of the foundation should be considered as income, and not capital.

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Both the original contribution and the income from it are ordinarily available to the foundation without distinction.

This would eliminate a device for avoiding unreasonable accumulation of income: contributions from one donor-controlled foundation to other foundations controlled by the same donor.

14. For the purpose of computing the accumulation of income, amounts unreasonably accumulated in corporations controlled by a foundation should be added to the foundation's direct accumulation as if the two were one.

15. Corporations controlled by foundations should be subject to the unreasonable accumulation earnings tax in section 531 of the Code. At present, that tax is imposed where dividends are held back to save the existence of unreasonable accumulations for foundations otherwise exempt from tax.

16. Re gift and estate taxes,
    (a) Exclude from the base for the marital deduction amounts left to foundations that are hence untaxed.
    (b) While amounts given to foundations are not subject to gift and estate taxes, the rate brackets to be applied to amounts that are taxable should be the same as if the foundation amounts were part of the taxable gifts or estate.

17. Consideration should be given to a regulatory agency for the supervision of tax-exempt foundations.

18. A penetrating review of every application for tax exemption is needed.

19. All matters relating to the granting or denial of tax exemption, as well as revocations and penalties, should be made public.

20. The full content of foundation tax returns should be open to public inspection.

21. A national registry of all foundations should be published annually.

22. The tax returns of foundations should require disclosure of amounts spent for instigating or promoting legislation, or political activities, or amounts paid to other organizations for the purpose.

23. The returns should likewise require disclosure of amounts spent for TV, radio, and newspaper advertising.

24. The returns should call for a description of all activities, directly or indirectly engaged in by the foundation, in which commercial organizations are also engaged.

25. The program of field auditing returns of foundation should be greatly expanded.

26. Stiff penalties and revocation of tax exemption for improper or insufficient reporting would help curb abuses.

27. A reasonable tax on income of foundations should be assessed.

These and other reforms are vitally necessary.

H. R. 13270 contains provisions dealing with some of these recommendations; others still remain.

A glance at these recommendations indicates quite clearly that while tax reform is extremely important, there are many other facets of the activities of these organizations which bear close scrutiny. Further, although H. R. 13270 is less restrictive than H. R. 7053, which I introduced in the House on February 18, 1969, I support the provisions of H. R. 13270 since I believe they are a step in the right direction.

For instance, H. R. 7053 recommended a 20 percent tax on gross income, but H. R. 13270 establishes a tax at 7½ percent on net investment income. Further, my bill recommended restricting stock ownership by foundations in corporations to three percent. The bill under consideration by your Committee allows 20 to 35 percent.

To place this entire matter in perspective, I would like to give some over-all statistics on those foundations under study by the Subcommittee on Foundations.

In the ten-year period ending 1960, 534 foundations had total receipts from all sources of $6.9 billion. In the succeeding seven-year period (575 to 647 foundations were studied), their receipts totalled $8.6 billion, or, $1.7 billion (25 percent) more in a three-year shorter period. These same foundations more than doubled their accumulated (unspent) income from $1 billion at the end of 1960 to over $2 billion at the end of 1967 and their net worth increased from $6.8 billion to $10.1 billion, or about 50 percent.

During the period from 1951 to 1967, these foundations had $15.7 billion in total receipts. Of this amount, $7.3 billion or somewhat less than half came from such sources as business income, interest, dividends, rents and royalties. Of the balance, $4.1 billion came from capital gains on the sale of assets and the remainder, $4.3 billion from contributions, gifts and grants.

At the end of 1967, the 647 foundations under study had total assets at market value of $17.8 billion, as compared to some $10.2 billion at the end of 1960; an increase of almost 75 percent. The $17.8 billion valuation is 50 percent greater than the $11.8 billion of the capital stock, surplus undivided profits and contingency

reserves of the 50 largest banks in the United States. When one considers that these figures are for only 647 of the 30,000 foundations, even though most of the larger ones are included, the size of the problem strikes one in full force.

One of my greatest concerns is the impact of such organizations on the small businessmen of this country. Foundations, because of their tax-exempt status can unfairly compete with a business which does not enjoy the benefits of such privileges. Holdings by foundations in enterprises constitute a powerful influence in corporate control, in the market place and in proxy solicitations. Our last report shows that almost 25 percent, or, 154 of the 647 foundations studied, held sizeable amounts of stock, from 5 to 100 percent in 313 corporations. The carrying value of these shares was $2.7 billion, with an estimated market value of $6.2 billion. The market value of all corporation stock holdings by these foundations amounted to the staggering sum of $13.1 billion, or, almost 80 percent higher than the holdings at the end of 1960.

As Fortune magazine of June 1969 states, "Philanthropy does get shortchanged however, when the corporate stock that a foundation holds for control purposes produces meager income." It cites the Lilly Endowment and the James Irvine Foundations as examples of disbursements representing only about one percent of its assets.

It would be interesting to take a look at what the foundations have done with their tax-free dollars. In the years 1951 through 1967, of the receipts of $15.7 billion, disbursements were $9.9 billion, of which $1.9 billion was paid out for expenses and $8 billion was distributed for contributions, gifts and grants. In other words, the foundations had distributed as contributions, gifts and grants only about 50 percent of what they had received; it cost them $25 in expenses for every $100 of contributions, gifts and grants made. However, this is an over-all average. When we look at 1967, we see that it cost the foundations $33 in expenses ($253 million) for every $100 in contributions, gifts and grants made ($754 million).

I am therefore constrained to view rather cynically the statements made by foundations' representatives that a 7½ percent tax on net investment income will seriously impair the ability of foundations to continue their philanthropic activities. This view is further supported when the record shows that the Rockefeller Foundation spent half as much just running its New York office - $5.4 million - as it spent throughout the entire nation in 1966. It spent more just running its New York offices - in salaries and the like - than it spent in "benevolence" in New York and California combined.

In fiscal years 1966 and 1967, the tax-exempt Ford Foundation lost $92,500 and $100,200 respectively in the operation of its cafeterias and dining room, and, of course, the taxpaying restaurant owners in New York City lost over several hundred potential customers.

In 1966 and 1967, the tax-exempt Rockefeller Foundation lost $44,500 and $47,200 respectively in the operation of its lunch rooms and taxpaying restaurant owners in New York City also lost several hundred potential customers.

Mr. Benson Ford received $15,000 for attending three meetings of the Ford Foundation.

I could go on and on giving examples of loose administrative practices, unconscionably high expenses, and free spending on the part of foundations. The reports issued by the Subcommittee on Foundations are replete with examples of complete disregard of the public interest in the operation of foundations.

If the foundation managers adopted a more prudent business-like approach to the cost aspect of their operations, exercised a more careful review of contributions, gifts and grants policies, and paid more attention to the kinds of income producing stocks in their portfolios, the 7½ percent tax, contemplated in H. R. 13270, would not be the burden they protest it would be. In fact, I would

hazard a guess that tightening their belts would make more funds available for charitable purposes.

The provisions of H. R. 13270 were reviewed in depth by me. While much more remains to be done, the provisions relating to privately controlled tax-exempt foundations will have a salutary effect on the operations of such organizations. I strongly support its provisions.

As I have indicated, much remains to be done with respect to the control and supervision of the activities of privately controlled tax-exempt foundations. The foundation problems are far more numerous and serious than Treasury officials have been willing to admit publicly. During our Subcommittee's 1964 hearings, I made the following statement, in part:

"The Secretary of the Treasury has testified that it is the Treasury's duty to be alert to all possible violations of law. The Secretary also says (1) he does not consider it proper for a foundation to engage in insider's stock deals, stock price manipulations, short sales, margin trading, speculation in commodity futures, or to act as an unregulated source of stock market credit, and (2) the SEC should be alerted to the possibility of a foundation's involvement in insider deals and stock price manipulations.

"Yet, testimony before this Subcommittee indicates the following:

"The IRS does not examine foundations to determine whether they are violating any Federal securities laws - including those relating to insider's stock deals, stock price manipulations, and unregulated sources of stock market credit.

"The IRS has not collected any information, as to the extent that foundations are involved in speculation and trading on margin.

"The IRS has not collected any data on the involvement of foundations in corporate proxy fights.

"The IRS does not examine foundations to determine whether their foreign operations may be in conflict with Government policies.

"The IRS does not examine foundations to determine whether the foundations are channeling income and corpus in a direction that may hurt competitors and investors.

"The IRS does not examine foundations to determine whether they are being used as a device for engaging in various trade practices which might be in violation of certain statutes administered by the Federal Trade Commission or the Antitrust Division.

"Few of the persons in the IRS who examine foundation tax returns would be sufficiently familiar with the antitrust law to know whether the practices as cited may violate Section 5 of the FTC Act or the Sherman Act.

"The IRS does not examine foundations to determine whether there is a conflict of interest between the duties of a foundation's directors or trustees and their interests as officers, stockholders and employees of business corporations whose stock is controlled by the foundation.

"The Acting Commissioner does not know of any cases where compensation of officers, directors or trustees among the large foundations has been unreasonable or unjustified. Yet, Mr. Benson Ford received $15,000 for attending three meetings of the Ford Foundation.

"The IRS does not review a foundation's individual charitable donations.

"The IRS has no rule of thumb regarding the percentage of income that a foundation must spend for the purpose for which it was granted tax exemption.

"The IRS does not examine foundations to determine whether contributions are being made to the foundations by persons or organizations that supply goods or services to companies interlocked with the foundations.

"The IRS does not know how much money was spent overseas by U. S. foundations in 1963.

"The IRS does not examine foundations to determine whether they are making loans overseas that may be contributing to our balance of payments problem.

"This is the most impressive record of do-nothing that I have seen in my 36 years in Congress."

I regret to say that those observations are just as pertinent today as they were in 1964.

The fact that foundations are exempt from taxation does not mean that they are exempt from other Federal laws. Hence, anti-trust law, FTC law, SEC law, etc. are applicable to foundations.

It is, of course, possible for a foundation to be used as a device for engaging in various trade practices which may be a violation of certain statutes administered by the Federal Trade Commission or the Antitrust Division. For example, contributions may be made to a foundation by (1) persons or organizations that supply goods or services to companies interlocked with the foundations, or (2) from persons or organizations that buy goods or services from companies interlocked with the foundation. The point is that if the company that is interlocked with a foundation is doing business with and by a contribution to the parent foundation they get the business because of that interlock, they are obviously getting an advantage.

In other words, a contribution can be made to a foundation for a business purpose rather than an eleemosynary purpose. For example, under the Robinson-Patman Act, business concerns are

prohibited from making disproportionate discriminatory discounts to particular buyers if the effect might be to substantially lessen competition or tend to create a monopoly. Hence, contributions to a foundation can be a method of getting around this provision of law.

Also, there is the business practice known as reciprocity, which may violate the antitrust laws. It involves tacit or actual agreement to do business with a firm if it reciprocates and gives business in return. Foundations may be parties to reciprocity arrangements. For example, a business affiliated with a foundation may say to one of its suppliers, " I will buy from you if you will contribute to such and such a foundation" or, "if you buy from me, such and such foundation will make you a business loan at favorable terms".

Our study indicates that many business suppliers and buyers have made sizable contributions to foundations controlled by customers. For example, we know that a number of suppliers of the Hilton Hotel chain are contributors to the Conrad N. Hilton Foundation, of Los Angeles. Mr. C. N. Hilton, Jr., Secretary of the Conrad N. Hilton Foundation, has acknowledged that, during the fiscal years ending February 28, 1952 through February 28, 1963, 29 donors - who were suppliers of goods or services to Hilton Hotels Corporation or its subsidiaries - made contributions to the Conrad N. Hilton Foundation in the amount of $61,695.18.

Does not this kind of situation appear to raise the specter of business reciprocity - We will buy from you if you contribute to our foundation?

If so, does it not raise a number of serious antitrust problems? Specifically, may it not involve a possible violation of the Robinson-Patman Act because it involves the inducement of discriminatory prices?

Or may it not involve a violation of Section 5 of the FTC Act as have other instances of business reciprocity because they involve "unfair methods of competition?"

Here is another case that we discussed in our hearings. The Rogosin Foundation, of New York City, is controlled by the Rogosin family. The Rogosin family has also dominated Beaunit Corporation (formerly Beaunit Mills, Inc.), Rogosin Industries, Limited, and Skenandoa Rayon Corporation.

At December 31, 1952, the Foundation held 33½ percent of the nonvoting preferred stock of Beaunit Mills, Inc. (carrying value $2.7 million) as well as 5 percent of the common voting stock of the same corporation (carrying value $1.9 million).

Beaunit Mills, Inc., manufactures synthetic yarn, knits and weaves fabrics, and manufactures intimate apparel. The Goodyear Tire and Rubber Company of Akron, Ohio, has been a buyer of tire-cord yarn from Beaunit Corporation.

In March 1952, Goodyear made a cash donation of $150,000 to the Rogosin Foundation. Additionally, on March 10, 1952;

Goodyear loaned $2.5 million to the Rogosin Foundation at 4 percent interest. The loan was to be paid off in installments due January 3-August 15, 1953, January 3 - August 15, 1954, and January 3 - August 15, 1955. According to the Foundation, payments on the loan were made on August 15, 1953, August 15, 1954, and August 15, 1955.

The Foundation states that it used the $2.5 million loan to purchase from Beaunit Mills, Inc., 30,000 shares of the latter's preferred stock. An identical number of shares of Beaunit Mills, Inc., preferred stock was pledged by the Foundation as collateral for the loan.

So, here we have the question as to whether this arrangement involves a price discount from Rogosin to Goodyear, for which Goodyear, the buyer, compensated Rogosin by making a contribution to the Rogosin Foundation. If this were the case, would it not seem to raise both tax and antitrust problems. First, it is a method whereby the buyer compensates the seller by making a tax deductible contribution to the Rogosin Foundation? Second, would not this practice, at best, be a distortion of the pricing and exchange process in a free enterprise economy? Third, might not this practice actually involve, (a) a violation of the Robinson-Patman Act because it involved discriminatory pricing, or (b) a violation of section 3 of the Federal Trade Commission Act because it is an unfair method of competition? Additionally, of course, Goodyear was acting as a source of unregulated credit.

Then there are the possible antitrust problems - actual or potential conflict of interest situations - that may stem from situations where board members of foundations also sit on the boards of business firms that compete with each other. As we all know, Section 8 of the Clayton Act provides that no person shall be a director of two or more competing corporations. Now, that Act does not apply to indirect interlocks, such as when a foundation has two board members, one of whom is also a board member of corporation A and the other member is on the board of corporation B (a competitor of A). While there is nothing illegal about such an arrangement under Section 8, there could be a special public interest problem when a foundation established for eleemosynary purposes becomes a vehicle for such indirect interlocks which might affect competition.

Here is another area that this panel should explore. Does a businessman in government pose a greater potential conflict of interest than the officials of foundations in government - such as, for example, McGeorge Bundy, President of the Ford Foundation, whose overlords, the Ford family, have immense commercial interests throughout the world, including the Middle East? It seems to me a bit inconsistent for the Congress to require a businessman to completely eliminate potential conflict of interest when, at the same time, it permits Mr. Bundy to wander in and out of the Government while retaining his $65,000 annual salary from the Ford

Foundation. This was the case in June 1967 when Mr. Bundy became Executive Secretary to the National Security Council Committee on the Middle East.

Now, to turn to the stock market - there is ample evidence that many foundations are actively trading in the market with substantial portions of their funds. Judging from the content of their portfolios and the frequency of turnover, many foundations are concerned less with equity yields and inflationary trends than they are with the lure of capital gains to swell their principal funds. I might add that former Secretary Dillon testified that he shares my view that speculative gains for charity are not worth the risk of speculative losses, and that he knew of no case where directors or trustees of a foundation have reimbursed the foundation for losses incurred in speculation.

One of the operations that should be subjected to the close scrutiny of this Committee is that of the private pooling of investments by some foundations - in other words, the pooling of capital to trade in the stock market. For example, some of the Rockefeller foundations have informed us that they have a joint investment staff of 16 persons, not including secretarial, headed by Mr. J. Richardson Dilworth, which provides investment services with the cost shared by the various Rockefeller participants.

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Does this not raise some potential problems - the possibility of speculative tactics, the possibility of a conflict of interest, the possibility of huge buying power that will have a strong impact on the prices of stock they deal in?

Secretary Dillon also testified that a foundation can be a source of unfair competition arising from active use of foundation assets by donors or trustees for private business ends, and that there are an infinite number of ways in which foundation assets or income can be used for the preferment of one set of private persons over another. The Secretary agreed that (1) foundations' moneylending activities put them into unfair competition with private lenders and also give the foundations an element of influence over a wide range of business ventures, and (2) such activities may present problems, such as preferential rates of interest. All this is made possible by the fact that, at present, the only restraint on a foundation's moneylending appears to be that loans must carry a "reasonable" rate of interest and adequate security, and that nothing prevents the foundation from making loans to its founder or his family, the businesses under his control, or a donor.

I conclude with this thought: There is something fundamentally wrong in conditions which make such acquisition of economic power possible, and which tolerate its continuation. And it is the responsibility of Congress to correct those conditions.

The Internal Revenue Service has proven itself over the years unable to administer and enforce effectively the laws and regulations governing such organizations. For many years the Subcommittee on Foundations attempted to obtain a list of privately controlled tax-exempt foundations. Finally, in December 1968, after many delays and much prodding, such a list was submitted to the Subcommittee. This list contained the names and addresses of 20,262 foundations. Shortly, thereafter, almost 300 corrections were made to the list.

In attempting to broaden our study of such organizations, and after unsuccessful attempts to obtain the kinds of information we needed from the Internal Revenue Service, we undertook to obtain the information by communicating directly with the foundations. We are presently in the first stages of such a project. Of the first several thousand mailings made, about 1,000 have been returned with the notations, "Moved, not forwardable," "Addressee Unknown," "Addressee moved and left no forwarding address," "Insufficient Address." In some cases we were advised that some foundations had been out of existence for years, one as long as ten years ago. The list furnished us by the Internal Revenue Service is replete with duplications and incomplete addresses and names.

If the Internal Revenue Service cannot even come up with the current addresses of the organizations for which they have responsibility, I shudder to think of the kind of audit and review .

that is being undertaken by them. Several years ago in one of our studies, we indicated that some of the larger foundations had not been audited for many years. In fact, as a result of prodding by the Subcommittee, some $28 million in assesments have been levied against a number of foundations.

The public is entitled to complete disclosure of information concerning these organizations which have been granted tax-exempt status. It is estimated that only 140 such organizations publish annual reports. The only other data is in the Form 990-A which is required to be filed with the IRS annually, which is admittedly limited in depth.

Recently, as a result of Congressional interest, there has been a great deal of scurrying around by the foundations to establish some kind of a self-policing organization. In view of the record, allowing such self-policing would be akin to having the fox guard the hen house or letting the goose watch over the shelled corn. Stronger Government action is urgently needed.

The proliferation in the number (2,000 new ones in the past year) of such organizations and in their increasing economic and other powers makes it necessary that their activities be given the closest scrutiny.

Accordingly, I introduced legislation in the House on September 9, 1969, (H. R. 13725) to establish an independent Government Agency to control and supervise the activities of

privately controlled tax-exempt foundations. Because of its relevance to the deliberations of this Committee, I would like to request that the text of this bill be included in the record of these hearings.

The new Agency, "The Private Foundation Control Commission," would be headed by three Commissioners appointed by and reporting to the President. Commissioners will serve five-year staggered terms with a Chairman whose term as Chairman would be co-terminus with the President's term.

As stated in the bill ..."The establishment of a Private Foundation Control Commission is necessary in the public interest to:

(1) provide general leadership in the identification and solution of problems relating to private foundations;

(2) facilitate the enforcement of internal revenue laws and regulations relating to private foundations and aid in the development of a more equitable tax structure with respect to such foundations;

(3) develop and recommend to the President and the Congress policies and programs designed to ameliorate the problems relating to Federal taxation and regulation of private foundations; and

(4) establish and administer a comprehensive registration and reporting system for private foundations and to determine

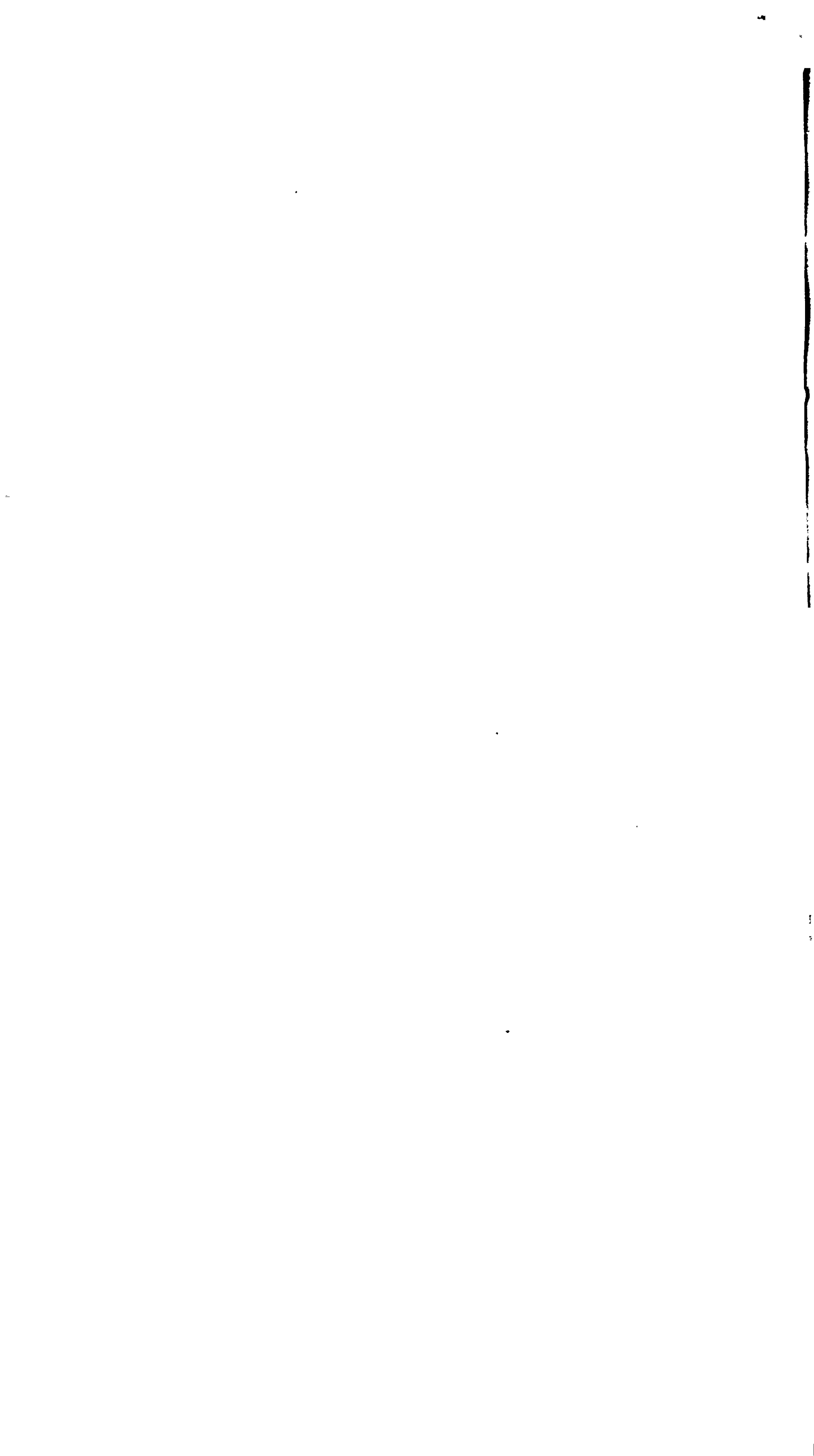
and centrally record the financial and other operations of such foundations in order to assist in the accomplishment of the foregoing objectives.

Under the legislation, no private foundation will be eligible for tax exemption unless it is registered with the Commission. The Commission would be authorized to revoke such registration under appropriate circumstances.

The Commission will be self-sustaining through assessing the foundations a registration fee and an annual maintenance fee. Such fees are not a substitute for the tax on net investment income of foundations included in H. R. 13270, the tax reform legislation recently passed by the House and under consideration by this Committee. The legislation is restricted to private foundations, which are defined in the legislation.

Mr. Chairman, I appreciate the time and courtesy afforded me in presenting this rather lengthy statement to the Committee. I would like to make it clear that my efforts are not directed to the elimination of all foundations as a constructive part of our democratic society. Rather, it is my hope that the corrective actions being considered by the Congress will clean up the bad apples in the barrel and allow those privately controlled tax-exempt foundations which are operating in the highest and best public interest to continue their worthy efforts.

In a democratic society, the burdens of taxation should be shared equitably by all. Privileges granted to any particular group for any special purpose must be accompanied by the acceptance of the responsibilities that such privileges carry with them. With the passage of this tax reform bill as passed by the House, and my bill (H. R. 13725) which I consider to be a companion bill, it is hoped that these objectives may be attained.



STATEMENT OF CONGRESSMAN CHARLES A. VANIK, OHIO

BEFORE THE SENATE FINANCE COMMITTEE

OCTOBER 3, 1969

Mr. Chairman:

After six trying months of effort on the Tax Reform Proposal, I can fully appreciate the difficult problem which confronts your Committee. The work of the House Ways and Means Committee and the House of Representatives is not perfect, but I believe you will agree that our deliberations were extensive, exhaustive and well-intentioned. Most of our decisions in Committee were arrived at after extensive discussion. Section by section we approved most of the language by almost unanimous vote. As you can determine by the Report Bill, there was, overall, very little dissention on major provisions of the Bill.

With this in mind, I endorse the principal provisions of the House Bill. Our decisions were made calmly and deliberately and in substantial response to the overwhelming mandate which each of us has clearly received from our constituencies. To my knowledge that pressure has not diminished one iota.

Neither the House of Representatives or the Ways and Means Committee initiated the drive for tax reform. We were pushed into it by angry taxpayers. The disclosure of abuses of the tax code ignited the bonfire. Taxpayer indignation at the escape from taxation of the super-rich, added fuel to the fire. The alternative to tax reform is open tax revolt.

There are some who would prefer to keep reform in suspension as a political issue, -- I would rather see a fair and reasonable proposal written into law. This reform proposal is in many instances only a soft touch on tax privilege instead of the heavy hand that I would like to see. It deals with no citizen unfairly. It is a step we must take toward tax justice.

Those who criticize our efforts to impose a minimum tax on the wealthy must find some other way of accomplishing this necessary goal. But that goal must be reached. The American public demands it.

Much has been said about our treatment of the Oil Depletion Allowance. Considering what could have happened, the small reduction in the depletion allowance enacted by the House was the minimum the taxpayer would accept. There can be no tax reform bill without some reduction of oil tax privileges. Nothing was done about intangible drilling costs, accounting procedures, and several other devices to spare oil taxation. The oil industry should be able to assume this taxation without threats to increase consumer prices. Blackmail will not work on the Congress or the consumer.

Domestic oil prices are artificially controlled by two state commissions working in unison toward price stability through production controls. Foreign oil import controls further prop up domestic oil prices at a consumer cost of billions of dollars. The authenticity of reports of depleting reserves must be measured against the advantages inherent in

suppressing reported reserves in an effort to shelter these reserves from taxation.

In one afternoon before the Ways and Means Committee, I dispelled the myth of natural gas shortages and the threat of a natural gas crisis. That information is in the House record.

Although the Administration has finally agreed to accept the Ways and Means Committee and the House recommendations for a reduction in the oil depletion allowance to 20 per cent, they have stated no position on the foreign oil depletion allowance which was completely eliminated by the House.

There is no rational legislative reason for extending the privilege of the depletion allowance to foreign produced oil. The combination of the depletion allowance and the foreign tax credit have made most of these profits tax free.

These tax-free profits of American investment in foreign oil have corrupted and misdirected American foreign policy in many oil-rich countries. This has resulted in American policies of costly military assistance in support of temporary rulers who will undoubtedly be removed when their people find out what is going on. There is no reason for the American taxpayer to subsidize these activities.

In some of the provisions of the Reform Bill, there may be room for improvement, particularly with respect to the language on charitable giving. I also hope that your Committee will consider providing taxpayer relief by way of increased exemptions. From projections of tax receipts which I have seen,

it would seem very feasible to increase exemptions at the rate of $100 per year, per dependent for the next four years until the dependency allowance reaches $1,000 per dependent. Every taxpayer relates the dependency exemption to the actual present day costs of support. To the taxpayer, this is far more meaningful than increased standard deductions which disregards family size.

In considering a taxpayer's fair share of taxation, it is important to know how a taxpayer must divide his available income among his dependents. This is hardly a boon to a wealthy taxpayer whose expense in supporting dependents escalates with his station in life. Poverty and large families are synonymous. Increased exemptions are the only method to relate the need for tax relief to family size.

One major objective of tax reform in the House which was not achieved is the critical need for simplification of tax returns and payment procedures. For the individual taxpayer, there is need for a simplified appeal procedure. As it stands now, the Tax Court procedure is a court for the rich. Less than one per cent of all challenged cases reach the Appellate Division of the Internal Revenue Service. Some lawyers argue that it is not feasible to take up a tax dispute unless the tax claim is upwards of $10,000.

What would be wrong with a system of small tax claim referees who could establish essential facts in small tax claims and provide a necessary and humane service for the average taxpayer.

In these days of high interest, it appears that the Internal Revenue Service is used as a bank by tax delinquents who pay 6 per cent interest on taxes owed the Federal government, using tax money for other purposes.

According to the latest Internal Revenue Service figures provided to my office, interest on delinquent taxes owed to the United States Treasury by individuals and corporations in Fiscal Year 1969 amounted to over $567 million. This amount of interest would indicate a $9.5 billion tax delinquency in Fiscal Year 1969! At this rate, the tax delinquency will increase in Fiscal Year 1970 by 12 per cent -- over $11 billion.

There is no joy to the Treasury collection of this interest at a 6 per cent rate. Who can get money cheaper than that? The delinquent taxpayer can invest these funds in absolute security at 8 per cent or 12 per cent. The delinquent taxpayer can profit by arbitrage at the expense of all other taxpayers who pay their bills.

It is incredible -- but the delinquent taxpayer has another useful gimmick. He can get a tax write-off against his current taxes for the interest he pays the Internal Revenue Service on his delinquent tax bill. This reward for delinquency adds a cruel insult to the average taxpayer who has to pay his tax bill before it is due.

. It seems to me that the tax reform proposal should be amended to raise the interest rate for delinquency and to eliminate the deduction for interest paid on delinquent taxes.

I know that your Committee is critically pressed for time in your deliberations. But there is a sense of urgency about tax reform which should prompt us to make difficult and responsible decisions this year.

SUMMARY STATEMENT OF GEORGE A. SMATHERS ON BEHALF OF MANUFACTURERS HANOVER TRUST COMPANY AND MORGAN GUARANTY TRUST COMPANY OF NEW YORK

Debt Securities Held By Banks

Banks have long received nonparallel treatment with regard to their capital gains and capital losses on bonds and other corporate and governmental evidences of indebtedness. A net gain on bonds is taxed as a capital gain; but a net loss on bonds is deducted against ordinary income. Section 443 of the bill would tax the net gain on bonds as ordinary income. For the reasons stated in the attached memorandum, we believe this provision should not be adopted. If it is adopted, such a change should be made effective only with respect to bonds or debt securities purchased after the effective date.

Bad Debt Reserves

It is believed not wise to limit bad debt reserves to relatively recent experience and thus ignore the impact of a possible future decline in the economy. The proposed bill would change from an existing uniform percentage formula for bad debt reserves which reflects depression experience to a formula consisting of each bank's own 6 year moving average experience. If such change is

to be adopted, then it seems inequitable to freeze the base year balances, as proposed under section 441 of the bill, in the case of banks who have not yet reached the 2.4% limit currently permitted and who are in mid-stream in a catch-up formula provided for by Internal Revenue Service rules currently in effect.

Lump Sum Distribution From Profit Sharing Funds

Under present law lump sum distributions from profit sharing funds are taxed at capital gains rates. The bill would substitute for this easily understood treatment a complex averaging formula requiring recomputation and refund claims by small taxpayers. It is submitted that the fairest and simplest method for averaging lump sum distributions from funds that have been built up over many years is the present capital gains treatment long permitted by the tax law.

STATEMENT OF GEORGE A. SMATHERS ON BEHALF OF MANUFACTURERS HANOVER TRUST COMPANY AND MORGAN GUARANTY TRUST COMPANY OF NEW YORK

Mr. Chairman, my name is George A. Smathers and I represent Manufacturers Hanover Trust Company and Morgan Guaranty Trust Company of New York. My remarks are limited to three sections of the bill: Section 443 relating to gains realized by banks on the sale of bonds and other debt securities; Section 441 relating to bad debt reserves; and Section 515 relating to lump distributions from profit sharing plans.

As explained in more detail under separate headings below, we believe the proposed changes embodied in these sections of the House Bill are inappropriate. In connection with Section 441 (bond transactions) and Section 443 (bad debt reserves), the Bill contains inequities which in any event should be corrected.

Debt Securities Held By Banks (Section 443)

Under present law, commercial banks are allowed to treat as ordinary losses any excess of capital losses over capital gains resulting from their transactions in bonds and other corporate and governmental evidences of indebtedness. At the same time, they are permitted to

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treat any net gains from such transactions as capital gains. Under Section 443 of the House Bill, this would be changed. Commercial banks would be obliged to treat net gains from these transactions as ordinary income instead of as capital gains. Net losses would continue to be fully deductible as ordinary losses.

It is not believed that this change is desirable. The present law is not the result of an unintended omission. The present treatment of losses on the sale of debt securities by banks dates back prior to World War II and was deliberately adopted to encourage financial institutions to support large new issues of bonds. It is not believed that it is in the public interest at this time to discourage financial institutions from acquiring bonds. The pendency of the House Bill already has had an adverse impact on the demand for long-term issues and has had the effect of reducing the already low liquidity of the banking system.

The modification of the present treatment of gains realized by banks on debt securities will increase the difficulty of the Treasury and state and local governments in issuing securities and consequently will tend to increase the cost of such financing. The impact on the present liquidity of the banking system arises from the fact that termination of the present treatment of gains will reduce the effective yield of issues now outstanding

and selling below face value. In short, we feel that there continue to be valid public policy objectives for maintaining the present nonparallel treatment of gains and losses.

If, despite the above considerations, the Congress sees fit to adopt the proposal embodied in the House Bill, it is submitted that such change should be made effective only with respect to bonds or debt securities purchased after the effective date. As indicated above, the present treatment was designed to encourage banks to perform the important functions of providing a market for governmental and corporate securities. It is therefore obviously inequitable that the current holdings of debt securities of banks which were purchased in the light of this favored tax treatment should not continue to enjoy such favored treatment.

Bad Debt Reserves
(Section 441)

For many years for federal income tax purposes, commercial banks have been permitted to establish bad debt reserves. The present regulation which was adopted in 1965 permits transfers to such reserves to be made until the total equals 2.4% of eligible loans. Transfers in any single year are limited by certain provisions designed to prevent unduly rapid or large transfers.

The present treatment is the result of regulations which have been modified from time to time after considerable deliberation. It cannot be regarded as an inadvertent loophole, but rather reflects broad public policy with respect to the structure and functioning of the commercial banking system.

Unlike many other nations, the United States has followed the policy of encouraging a high degree of decentralization in our banking system. As a result, there are more than thirteen thousand commercial banks in the United States, the great majority of which are small enterprises. It is of the utmost importance that the stability and solvency of this system be assured. Bad debt reserves have contributed to such solvency and stability.

Subject to a transition rule designed to prevent hardship, Section 441 of the House Bill would eliminate the present rule which permits a bad debt reserve of 2.4% of outstanding uninsured loans and would substitute therefor a reserve based upon each bank's own experience as indicated by losses for the current year and the five preceding years.

While in a period of economic stability, the present rule permitting a reserve of 2.4% of eligible loans may result in a reserve that is more than adequate for many banks, it is submitted that it is important that banks be permitted to have a cushion against the possibility

of an economic downturn. In the absence of such a cushion, many banks throughout the country could, in the event of a recession, suffer such an impairment of capital as to force liquidation or reorganization. The undesirability of this from the standpoint of the entire economy is obvious.

If, despite the above considerations, the Congress should determine to adopt the proposed change to a six-year moving average, there is one inequity in the Bill which should, in any event, be corrected. This inequity arises in connection with the transition rule which is designed to prevent hardship where a bank has a bad debt reserve in excess of the amount that would be allowable on the basis of its own experience. The transition rule, as embodied in the House Bill, would permit the bank to maintain its present dollar reserve and to deduct actual bad debt losses where no addition to the reserve would be justified under the six-year moving average. The inequity stems from the different levels and circumstances in which individual banks find themselves with respect to their reserve balances as of the close of 1969 and in light of an incomplete transitional formula by which they are governed under existing Revenue Ruling 65-92.

By way of background, Revenue Ruling 65-92, issued by the Internal Revenue Service in 1965, was designed to provide a uniform percentage for computing

annual additions to reserves for bad debts by banks. Under the ruling a bank was allowed deductions for additions to its reserve for bad debts until the reserve equals 2.4% of loans outstanding at the close of the taxable year. However, in order to minimize the revenue impact and still put banks on a parity, a bank whose reserve was less than 2.4% of outstanding loans at the close of its 1964 taxable year (the year of change) was permitted to make up the difference over a period of not less than 10 years. This "catch-up" period runs at least through 1974. As a result, many banks' so-called "base year" balance in their reserves are at the 2.4% limit but other banks are still in the process of increasing their reserves to that limit under the Internal Revenue Service formula.

In moving from the existing uniform percentage formula for bad debt reserves to the proposed new experience formula, it seems inequitable to freeze the base year balances in the case of banks who have not yet reached the 2.4% limit and are in mid-stream in the catch-up formula under existing law.

As part of the transition to the proposed new formula, banks whose base year balances have not yet reached the 2.4% limit should be able annually to increase such balance by at least the amount of their experience under the new formula until such balance reaches the 2.4%

ceiling for the base year. The effect would be to reach a greater degree of equivalency among competing banks (which was the purpose of Revenue Ruling 65-92) over a period of time but by a formula tied to actual experience as proposed in the bill. Stated differently, our proposed change would permit a gradual equalization in the point of departure of change from existing to newly proposed bad debt reserve rules. Had the Internal Revenue Service catch-up formula run its course for all banks prior to the pending legislation, such a change would not have been necessary.

Tax Treatment of Lump-Sum Distributions
From Profit Sharing Funds
(Section 515)

Section 515 of the Tax Reform Act of 1969 pertains to the taxation of distributions from profit sharing plans. That section, as contained in the Act passed by the House of Representatives, would tax as ordinary income that portion of a lump-sum distribution from a profit sharing plan which consists of amounts contributed by the employer after 1969. Under present law, such amounts would be taxed at long-term capital gains rates. This change appears undesirable.

At the outset, it may be helpful to describe in general terms the provisions of the profit sharing plan of Manufacturers Hanover Trust Company, which are believed to

be typical of those of many other banks. Manufacturers Hanover Trust Company has adopted this plan in addition to a fixed benefit retirement plan. The employee looks primarily to the fixed benefit retirement plan to provide him with security in retirement. The profit sharing plan serves the purpose of permitting the employee to share in the Bank's profits and of encouraging him to be thrifty. It makes it possible for him to accumulate a sum which will enable him following retirement to travel, to purchase a home in a vacation area or to invest in a small business. The imposition of confiscatory taxes is inconsistent with the achievement of these purposes.

Under the plan, all regular employees become eligible to participate after the completion of one year of continuous service. Each year, the Bank sets aside for profit sharing under the plan 10% of net operating earnings after taxes. The sum so set aside is allocated among the employees in the proportion that each employee's base compensation bears to the total base compensation of all employees participating in the plan. The employee is not obliged to make any contribution to the plan.

The employee is given the right to elect to have his share in the profit sharing fund invested in whole or in part in one of four different Investment Funds. One of these funds is invested in stock of the employer bank. The

other three funds consist of miscellaneous securities, the most conservative consisting solely of U.S. Government obligations, another of relatively conservative securities (including, however, common and preferred stocks), and the third of a less conservative type of securities.

Three methods of payment are provided: (a) a lump-sum payment, (b) annual installments of not more than ten in number and (c) purchase of an annuity contract. While the method of payment to each employee is decided by a Retirement Committee, the employee's desires are taken into account. If the share of the employee has been invested in securities of the employer bank, the payment will be made in this medium if requested by the employee.

It is believed that in the light of this description of the profit sharing plan of Manufacturers Hanover Trust Company it is possible better to understand the tax treatment of profit sharing distributions. The present law which has been in effect for approximately twenty-five years provides for capital gains taxation of lump-sum distributions if they are made in one taxable year as a result of separation from service; and where the distribution includes securities of the employer corporation, such securities are valued at the original cost thereof to the plan, any appreciation up to the time of the distribution being ignored.

As a result the unrealized appreciation is not taxed until the employee later sells the securities.

Under the House Bill, the existing rules would be changed to impose ordinary income tax, rather than long-term capital gains treatment, on that portion of a profit sharing distribution which consists of employer contributions attributable to years beginning with 1970. The Bill provides a special averaging device to minimize somewhat the effect of the "bunching" of income in the year of retirement. Under this device, one-fifth of the employer's contributions would be added to the other income of the employee and a computation would be made to determine the tax on such one-fifth. The tax so arrived at would then be multiplied by 5 to determine the total tax to be paid by the employee on the contributions of the employer. The Bill contains a further novel provision which permits the employee to recompute his tax for the taxable year of retirement and each of the four following taxable years (on the assumption that the lump-sum distribution has been paid to him in five equal annual installments), and if such computation produces a lower tax than that in fact paid by him, permits him to file a claim for refund.

Except for this change in the method of taxing the portion of the lump-sum distribution representing employer contributions, the House Bill makes no change in the

present law with respect to the tax treatment of profit sharing distributions. To the extent that a lump-sum distribution is attributable to earnings realized by the fund over the years in which the employee has been participating in the plan, the distribution would be taxed as long-term capital gain. Likewise no change would be made in the rule which, in the case of distribution of employer securities, disregards the unrealized appreciation on such securities. Accordingly, the tax on such unrealized appreciation would be deferred until the employee realized the same through a sale of the securities.

At this point, it is well to note another change proposed by the House Bill which, although not specifically related to profit sharing, does have an effect on the taxation of profit sharing distributions. This is the proposed removal of the 25% maximum tax on long-term capital gains. We are not expressing any view on the wisdom of this proposed change, but are referring to it merely for the purpose of pointing out that even if the provisions of Section 515 of the House Bill are eliminated as herein recommended, the tax payable on lump-sum distributions from profit sharing plans will not as under existing law, be limited to a maximum rate of 25%.

It is our position that irrespective of the tax rate, the capital gains method of taxing lump-sum distributions

from profit sharing funds is preferable to that proposed in the House Bill both from the standpoint of fairness as well as from the standpoint of practical administration.

The capital gains treatment which under present law is applicable to lump-sum distributions from profit sharing plans is not a method of taxation peculiarly reserved to the taxation of gain on securities and other capital assets. Rather it is a method which was devised for the taxation of income accumulated over a number of years which under the "annual accounting" concept followed by our tax law is "bunched" into one year. Lump-sum distributions from profit sharing plans represent an accumulation over many years of service, sometimes as many as thirty or forty years, which is received by the employee in one taxable year. No better illustration could be found of the type of situation for which the capital gains method was devised. Capital gains treatment further is appropriate to these distributions because an employee's profit sharing account represents an investment which he has had at risk throughout his employment. During this entire period he was the true owner of his share in the fund even though such share may stem from contributions made by the employer. While the moneys are in the profit sharing fund, the employee is subject to the risk of the fluctuations of the securities markets. If the investment experience is good,

the employee stands to gain; but if it is bad, it is the employee who will bear the loss. It thus appears entirely appropriate to apply the capital gains treatment to these distributions without any fragmentation such as is proposed by the House Bill.

If it be suggested that ordinary income treatment is appropriate to the extent of the employer's contribution because such contribution is attributable to the employee's own labor, it is submitted that this argument prove too much. If it were sound, ordinary income taxation would be appropriate to the proprietor of a small business who sells the business after a long period of time over which he has built up the good will of the business. Such a proprietor is of course given capital gains treatment on the sale of his business even though what he is selling obviously stems largely from his own personal efforts. In this connection, it is to be noted that the philosophy underlying the proposed change in the tax treatment of lump-sum distributions appears inconsistent with the philosophy underlying the provisions of Section 802 of the House Bill which propose a maximum tax rate of 50% on earned income. Implicit in the latter provision is a recognition that our tax laws in the past have unfairly discriminated against earned income such as salaries and other forms of compensation, and that the imposition of confiscatory taxation may result in discouraging further

effort on the part of both low and high-paid employees who recognize that as their compensation increases, the percentage thereof that goes to the Government likewise increases. Since distributions from profit sharing funds are a means of encouraging employees to greater effort, it seems that the proposed elimination of capital gains treatment is a movement in the wrong direction.

The House Bill recognizes that it would be inequitable to tax a substantial portion of a lump-sum distribution as ordinary income in one taxable year. Accordingly, it adopts the above-mentioned averaging device as well as the cumbersome refund procedure. This necessary averaging is, it is submitted, better accomplished, with less administrative burden to both the taxpayer and the Internal Revenue Service, by leaving the present capital gains treatment undisturbed. The present law achieves an equitable result in a way that is easily understood by taxpayers and is capable of easy administration by the authorities. The proposed treatment including particularly the refund provision would be very difficult of comprehension by unsophisticated taxpayers. In many instances, the refund provisions would have to be utilized by the estates of deceased employees under circumstances where the necessary records would be difficult to locate.

The proposed averaging device, while it avoids the extreme pyramiding of income which would result in the absence of an averaging device, fails fully to take into account that much of the distribution may represent earnings of the employee when he was being paid a very modest salary and, consequently, was in a low tax bracket. Many of the employees of a bank start at the very bottom of the ladder and after many years reach a level where their top income is subject to tax at high surtax rates. The 5-year averaging device will in those cases fail to level out the rate of taxation in a manner that properly reflects the rates which would have been applicable had the employee received the payments in the years in which he rendered the services. Capital gains taxation, it is submitted, more closely approximates the tax which would have been paid if the moneys had been distributed currently. This will be particularly true if, as provided in the House Bill, the 25% maximum tax rate on long-term capital gains is eliminated.

The refund provision of the House Bill, which would entitle the employee to a refund at the end of 5 years if he has relatively small income during the 5-year period following termination of service, is addition to being subject to the criticism that it is administratively cumbersome, is unfair in that it will deprive the employee for a period

of 5 years of the use of the money which is ultimately refunded to him.

In conclusion, it is submitted that the present provisions of the Code properly apply capital gains treatment to lump-sum distributions in recognition of the fact that the employee has an investment in the profit sharing plan which is at risk over a long period of time. These provisions are equitable, understandable and result in a fair approximation of the tax which would have been paid over the period of years in which the average employee participates in a profit sharing plan. A tax provision which governs payments to many low-salaried employees should in all events be simple and easily understood. The provision in the House Bill fails completely to meet this test.

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

1705 De Sales Street, N. W.
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REPORT ON H.R. 13270
TAX REFORM ACT OF 1969
91st CONGRESS, 1st SESSION

This report has been prepared by the Section of Taxation and has not been approved by the House of Delegates or the Board of Governors of the American Bar Association, and should not be taken as representing the opinions, views, or action of the American Bar Association, its House of Delegates, or Board of Governors, unless expressly so stated herein, but only the opinions, views, or action of the Section of Taxation.

October 1, 1969

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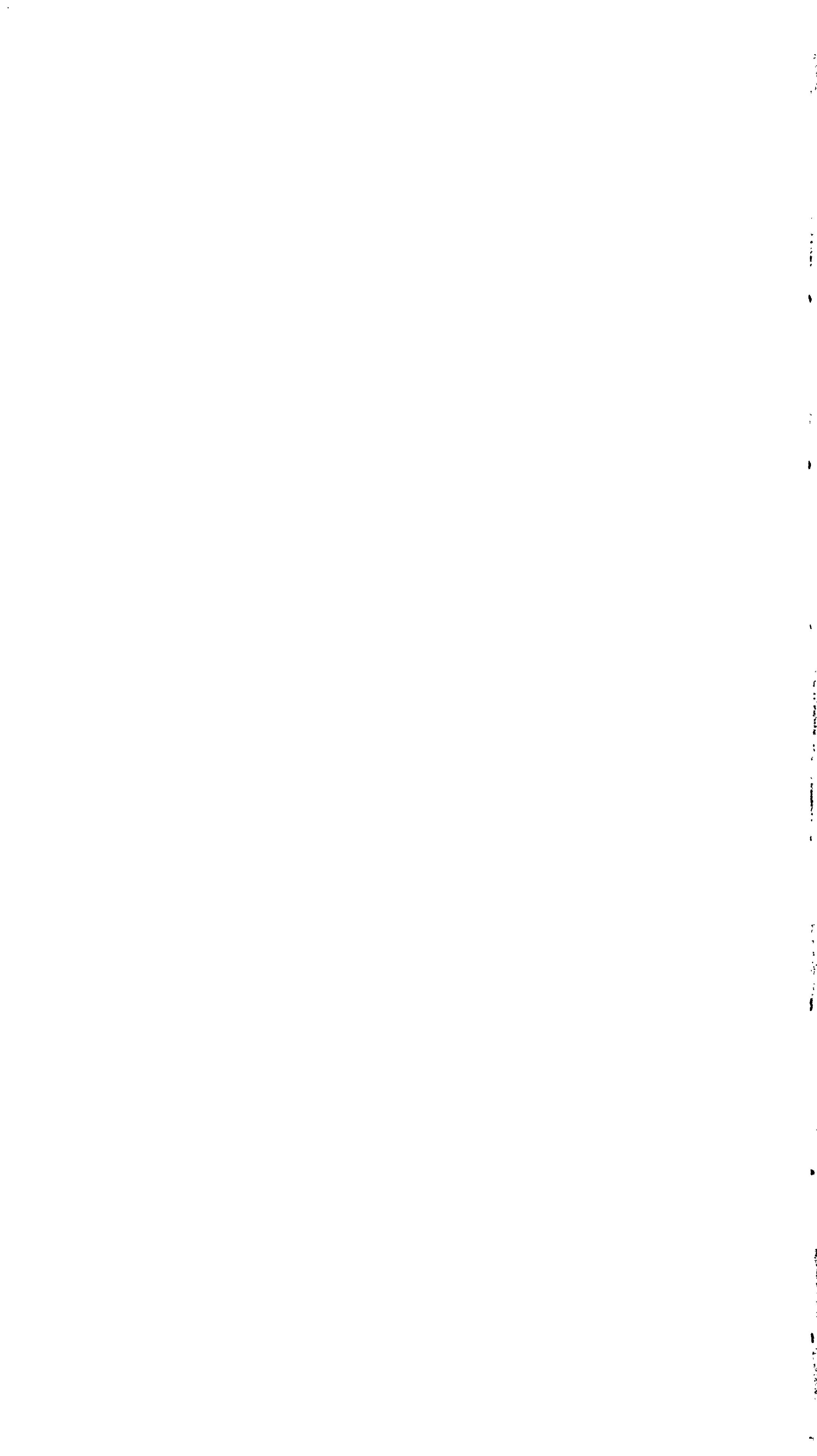

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

REPORT ON H.R. 13270
91st CONGRESS, 1st SESSION

Introductory

This report of the Section of Taxation of the American Bar Association on H.R. 13270, 91st Congress, 1st Session, The Tax Reform Act of 1969, has been prepared for submission to the Senate Committee on Finance in connection with its hearings on the bill. The report represents only the opinions, views, or action of the Section of Taxation, and nothing herein is to be construed as representing the opinions, views, or action of the American Bar Association, its House of Delegates, or Board of Governors, unless expressly so stated herein.

The Section believes that the bill makes many desirable reforms in the Internal Revenue Code. However, to conserve time we have largely limited our report to comments on problems of statutory draftsmanship, undue complexity in the structure of the tax law, and alternative methods of accomplishing the same general objectives.

There are two recurring problems that merit preliminary comment. The first is the retroactive effective dates and the second is the delegation of legislative powers.

The Section of Taxation has heretofore adopted the following policy on retroactivity:

> Retroactivity is determined with reference to the date upon which the amendment becomes law. It is recognized that in some cases publicity attendant upon a proposed amendment may induce taxpayers to take advantage of an existing "loophole." Nevertheless, the foreclosure of such last-minute tax avoidance is considered less important than the preservation of the principle that a taxpayer may rely upon an existing statute in planning his affairs.

We urge that these principles be applied to the fullest extent possible in this bill.

There are many instances where the bill provides for supplemental details to be provided by Treasury Regulations. In some sections the bill provides standards to be followed by the Secretary of the Treasury or his delegate. However, in many sections no standards are provided.

The Section of Taxation after prolonged consideration adopted the following suggested statement of policy in this regard:

> Since the Treasury has the general statutory power to issue reasonable regulations, an express delegation of the legislative function to the Treasury in a particular statute serves no useful purpose. The legislative program should be scheduled so that there is sufficient time to incorporate all major policy decisions within the statute. It may be appropriate, however, for the statute to indicate that specified procedures and administrative detail are to be prescribed by regulation.

We urge the Committee to give serious consideration to these principles when reviewing the many delegations of rule making power.

TITLE I—TAX EXEMPT ORGANIZATIONS

SUBTITLE A—PRIVATE FOUNDATIONS

Sec. 101. Private Foundations

Bill pp. 5-6, § 101(a) [IRC new § 506]
Tax on Investment Income

1. This provision appears to be designed primarily to raise funds to pay the increased expenses of the Internal Revenue Service in administering the audit program for private foundations under the Tax Reform Act of 1969. The rate of tax, therefore, should be only that which is reasonably necessary to raise the required funds. We recommend that, in lieu of a tax on income, an excise tax be imposed on all receipts from all sources of private foundations. Such a change would simplify the statute as well as simplify the computation of the tax. We believe that a tax on receipts would be as accurate a measure of audit costs as a tax on net investment income.

2. If the section is enacted, the following changes are recommended. Section 506(b)(3) of the bill provides that the deductions from gross investment income allowable in determining net investment income of a private foundation are in substance those now available to individual taxpayers under the first two paragraphs of section 212 of the Internal Revenue Code. Presumably, therefore, such deductions would not include those allowed under the third paragraph of present section 212 (expenses incurred in connection with the determination, collection, or refund of any tax) even though such expenses might be incurred in connection with the determination of the taxes imposed by

sections 506, 507, and chapter 42 of the bill. We recommend the allowance of a deduction for such expenses.

Similarly, the bill does not provide for a deduction for interest, taxes, losses, bad debts, amortizable bond premium, depletion, or depreciation with respect to investment assets. We believe that such deductions should be allowed in determining net investment income subject to the tax. Note that the Report of the Ways and Means Committee (H. Rep. No. 91-413, 91st Cong., 1st Sess., Parts 1 and 2, hereinafter referred to as "House report, part —") specifically states that a deduction for depreciation will be allowed. (House report, part 2, p. 2).

Section 506(b)(4)(B) provides that in determining net capital gain or loss of private foundations "there shall be taken into account only the sale or other disposition of property" used to produce gross investment income or unrelated business income except to the extent accounted for under section 511. It is not clear whether the capital gain income intended to be taxed is only that which otherwise would be taxable under applicable provisions of the Internal Revenue Code. The use of the word "disposition" would appear to include gains that are not otherwise recognized as, for example, those arising from involuntary conversion or in connection with tax free reorganization exchanges.

Bill pp. 6-11, § 101(a) [IRC new § 507]
Tax on Termination of Private Foundation Status

1. This section is highly complex and contains serious procedural deficiencies. Consideration should be given to an alternative provision which would permit a private foundation desiring to terminate its status to do so free of penalty by transferring its assets to a charity qualifying as public under section 170(b)(1)(B) as amended by the bill. If the Secretary or his delegate gives a private foundation notice of termination of its status pursuant to section 508(e), no tax would be assessed for a reasonable period, pending action by the appropriate State authority to transfer the assets of the foundation to another charity under the applicable State law relating to the doctrine of cy pres. If the State does not act within this period, a tax equal to 100 percent of the assets would be imposed.

2. If section 507 is enacted in its present form, a transition period should be provided to permit existing section 501(c)(3) organizations to determine through rulings whether they are private foundations and, if so, what they may be required to do to convert themselves into public organizations meeting the qualifications of section 170(b)(1)(B).

Section 507(e) provides that the Secretary or his delegate *may* abate

the unpaid portion of any tax imposed under section 507(a) if the private foundation satisfies the requirements of section 507(e). The abatement should be mandatory not discretionary.

Section 507(f) provides that in the case of a substantial contributor (anyone who contributes more than $5,000 in any year) the disallowance of the deduction will relate back to the date of the first act of the foundation culminating in the loss of its exemption. This unrealistically assumes that a substantial contributor will have knowledge of such act and be in a position to prevent it. Furthermore, subsection (f) applies to estate tax deductions and hence, the disqualifying act may occur after the date of death.

Bill pp. 11-15, § 101(a) [IRC new § 508]
Special Rules with Respect to Section 501(c)(3) Organizations

Section 508(b) provides that any organization described in section 501(c)(3) which does not notify the Secretary or his delegate that it is not a private foundation shall be presumed to be a private foundation. A further provision should be added to subsection (b) to provide that late filing of such notification, if not delinquent after specific notice to the foundation, will prevent the automatic classification of the foundation as a private foundation.

In section 508(c) there is no need to state expressly that churches and schools *may* be exempted from these procedures, since the general authority given to exempt any class of organization would cover such organizations.

In section 508(e), the termination of status tax under section 507 can be invoked by the Secretary or his delegate if the organization so acts as to give "rise to liability for tax under chapter 42," i.e., the taxes on self dealing, failure to distribute income, etc. The following points are not clear:

a. Must the liability for tax under chapter 42 be finally determined before the termination of status tax under section 507 can be invoked? Or is it enough that a notice of deficiency for tax under chapter 42 be issued? Or is it enough that the Internal Revenue Service merely assert, as on field audit, that there is such a deficiency?

b. Will a final determination that there is no liability under chapter 42 necessarily preclude the tax under section 507?

c. No statute of limitations has been provided for the assessment of the tax under section 507 (see page 64, line 3, of the bill). Some reasonable limitation period should be provided.

d. A drafting problem arises on page 12, line 21, and page 13, lines 9 and 14, in referring to subsection (e) as a section with which

the organization "has complied" because subsection (e) of section 507 involves a discretionary abatement of tax by the Secretary. "Compliance" is up to the Secretary, not the organization.

The requirement of section 508(g) that the governing instrument of the private foundation contain certain provisions is unnecessary. The statutory requirements for exemption are clearly set forth in section 501(c)(3). The addition required by section 508(g) merely restates the operational tests for continued exemption elsewhere required by the bill. To require the change in governing instruments to include the stated provisions would impose undue hardship on many thousands of tax exempt organizations. To receive and file the amended instruments would also be an unnecessary burden upon the Internal Revenue Service. State agencies and courts would likewise be burdened in making or authorizing the making of the unnecessary changes.

Bill p. 15, § 101(a) [IRC new § 509(a)]
Private Foundation Defined

1. Section 509(a)(2) sets forth the test for determining whether an organization receives adequate public support to avoid the definition of private foundation. It is not evident why subparagraph (B) states that no more than one-third of the foundation's support can come from investment income. For aught that appears, the investment income could have been generated from an endowment that was received from public contributions. It should be sufficient that one-third of the total support comes from gifts and the specified related sources.

2. Clarification is needed for the meaning of the term "grants," particularly whether grants are in the nature of gifts (as referred to in new section 509(a)(2)(A)(i) and in section 102) or income (as referred to in new section 509(a)(2)(A)(ii) and in section 61). If, for example, a research grant is received that contemplates the preparation of a report, it might be treated either as a grant under clause (i) or a fee for performance of services under clause (ii). If such a grant is treated as a grant under clause (i), the 1 percent test of clause (ii) would not apply.

3. Section 509(a)(3) excludes from the definition of a private foundation an organization which is organized, and at all times is thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more organizations described in paragraph (1) or (2). The Congressional intent should be clearly expressed whether private foundation status exists in the following cases: (1) a trust which was originally established for private and public purposes (i.e., for the benefit of private annuitants and charity), but which

later becomes operated solely for public purposes (i.e., upon the death of the private annuitants); and (2) an organization with a defective charter which could be amended ultimately to satisfy the "organized" test.

4. There appears to be no reason why an exempt charitable organization which is operated "in connection with" two or more qualified institutions should not be protected as well as one which serves only *one* qualified institution. Section 509(a)(3)(B), on page 16, appears, however, to apply only to the *one* institution situation.

5. Some attempt should be made to define the term "support" since the present use of that term under Regulations section 1.170-2(b)(5)(ii) may not be entirely consistent with the scope intended of section 509(a)(2). For example, under the section 170 regulations, support excludes amounts received in furtherance of an exempt function and includes unrelated business income. Section 509(a)(2) suggests that support includes amounts received in furtherance of an exempt function and excludes amounts received from an unrelated trade or business.

6. On page 16 of the bill, line 21, the word "and" should be changed to "or." Otherwise all paragraphs of section 509(a) would have to apply in order for an organization to escape classification as a private foundation. The intent clearly is that any one of the four paragraphs defines an organization which will escape classification as a private foundation.

Bill pp. 17-25, § 101(b) [IRC new § 4941]
Tax on Self-dealing

1. In section 4941(e)(3) the phrase "dealing under the highest fiduciary standard" is used. It is not known what this means or to what standards the provision refers unless the self-dealer in effect becomes an insurer.

2. The definition of "correction period" in section 4941 uses different language than the definition of "correction period" in sections 4942 and 4943. In those sections the "correction period" may be extended for a period determined to be "reasonable and necessary" to make the correction, whereas in this section the "correction period" may be extended for a period which is "conducive to bringing about correction." The reason for this difference is not clear.

3. Subsection (c) is ambiguous as to the liability of a foundation manager where it provides under subsection (c)(1) that the liability shall be joint and several and in subsection (c)(2) that the liability shall not exceed $10,000 as to a foundation manager. If the liability is joint and several under subsection (c)(1), it might exceed $10,000 regardless of subsection (c)(2).

4. Reference is made to the definition of a government official in section 4946(c). It would seem that a government official could be defined in something less than a page and a half of a statute—e.g., "an employee who receives an annual salary of $15,000 or more, and his personal or executive assistant or secretary."

5. In subsection (d)(2)(E) the word "reasonable" should be substituted for the words "not excessive."

6. One of the effective date provisions (Bill p. 81) exempts the sale to a disqualified person of property owned by the foundation on May 26, 1969 if such sale is necessary to comply with the rules on excess business holdings (section 4943). This provision should be cross-referenced in section 4941 to section 101(k)(2)(B) of the bill.

Bill pp. 25-34, § 101(b) [IRC new § 4942]
Tax on Failure to Distribute Income

1. The House report, part 1, pp. 26-27, states that the tax is imposed for each year until the private foundation is notified of its obligation to make distributions or until the foundation itself corrects its earlier failure by making the necessary payouts. The fact that there is an annual tax is by no means clear from reading section 4942(a). The purpose of the parenthetical clause beginning on line 25 of page 25 is not clear.

Neither is it clear when and how the tax liability is to be determined. Presumably the private foundation will not be confronted with an assertion of liability until the Secretary or his delegate sends a notice of deficiency. This could be some years after the asserted failure to distribute income.

2. On page 26, lines 15 and 16 and on lines 19 and 20, reference is made to "any time" in determining when income of a private foundation is undistributed. There is no apparent reason why the determination of the amount of undistributed income cannot be made as of the end of an annual accounting period or taxable year. It seems plain, however, that it was not intended to do so, because the provision just mentioned, taken in connection with new section 4942(h) on page 31, indicates that tracing will be needed in order to determine, *during* any taxable year, whether a distribution is from income of the immediately preceding taxable year or from income of the taxable year. Such tracing will entail complications of accounting. It would seem preferable to use the concept employed in personal holding companies, i.e., treat a distribution within a limited period after the close of a year as having been made from the preceding year's earnings.

3. Section 4942(e) refers to the minimum investment return "for any

taxable year." This is computed by applying the applicable percentage to the fair market value of the foundation's assets. Paragraph (2) describes the valuation to be used. The value of securities for which quotations are readily available is to be determined on a monthly basis. Other assets are to be valued at such times and in such manner as the Secretary or his delegate shall by regulations prescribe.

In the House report, part 1 at page 25, it is said that the base upon which the applicable percentage rate is to apply is the average value of the non-charitable assets during the taxable year. Paragraph (2) of the bill on page 27 should state that the value should be an average one. Preferably, however, the computation of the base upon which to compute the minimum investment return should be the lowest fair market value during the foundation's taxable year.

Use of an annual instead of a monthly valuation procedure is consistent with other provisions of the bill. See, for example, bill page 115 at line 7 and page 137 at line 6.

4. In section 4942(e)(3) the applicable percentage for taxable years beginning in 1970 is 5 percent. Presumably this is deemed to be an appropriate yield for 1970 on income producing property. If it is, the use of the 5 percent figure leaves out of account the previously imposed burden of the tax on investment income imposed by section 506, and the 5 percent figure should be reduced accordingly. Alternatively, the section 506 tax should be included as a qualifying distribution under section 4942(g).

There is a fundamental question whether 5 percent is the correct percentage to use for 1970. Based upon many economic studies and surveys, and the Dow Jones industrial average, a 3½ percent figure would appear to be more reasonable. The use of 5 percent may require continuing corpus distributions from foundations which are funded substantially with equities instead of fixed obligations.

5. Section 4942(f)(3)(A) allows as deductions in computing adjusted net income only the deductions that are ordinary and necessary expenses paid or incurred for producing or collecting gross income or for the management, conservation or maintenance of property held for the production of such income. These are the deductions allowed by section 212 except for the deduction provided in section 212(3) for ordinary and necessary expenses paid or incurred in the taxable year in connection with the determination, collection, or refund of any tax. Thus, no deduction would be allowed for expense of contesting the tax incurred under chapter 42, for example, on the failure to distribute income. This does not seem equitable.

Deduction is not, but should be, allowed for interest, taxes, losses,

bad debts, amortizable bond premium, depletion, and depreciation with respect to investment assets.

6. As noted above, a payment of the tax under section 506 should be treated as a qualifying distribution unless the applicable percentage is changed to accommodate the impact of the section 506 tax in determining the minimum investment return under section 4942(e).

In defining a qualifying distribution there is no provision in subparagraph (A) to treat as a qualifying distribution amounts required to be disbursed in defraying costs of administering the charitable program and costs incurred in earning investment income. These amounts should be deducted before a tax is asserted for failure to distribute either the minimum investment return or the adjusted net income.

7. Section 4942(g)(1)(A) excludes from classification as a qualifying distribution an amount paid to an organization "controlled (directly or indirectly)" by one or more disqualified persons. A definition of the quoted phrase should be included or provided by cross-reference. Does control mean ownership of stock having 51 percent or 80 percent of the voting power? Do the attribution rules apply in determining control?

Section 4942(g)(1)(B) treats as a qualifying distribution any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in section 170(c)(2)(B). If a distribution is made in the acquisition of an asset which the Internal Revenue Service claims is not used directly in carrying out one of the stated purposes, the fact is that the distribution will nevertheless have been made and no income will remain after the expenditure from which to pay a tax which would result from not having the benefit of the qualifying distribution. Moreover, the shortage of qualifying distributions thus occasioned would be a permanent condition which would continue indefinitely with the result that the income so used would each year during the continued existence of the foundation be subject to the 15 percent tax imposed by section 4942. If that is the intention of Congress, it should be clearly stated.

Section 4942(g)(2) should be worded so as to permit a foundation to set aside income where controversy has developed over potential liability for taxes, legitimacy of the charitable trust or proper application of income or corpus in suits by heirs, and similar circumstances dictating needs to accumulate earnings which are not strictly charitable.

8. Section 4942(h)(1) provides that distributions made during a taxable year shall be treated as made, first out of undistributed income of the immediately preceding taxable year, second out of undistributed income for the taxable year, and finally out of corpus. The extent to

which annual accounting periods will be ignored for purposes of determining the source of distributions is not clear.

The distribution is treated as first out of undistributed income of the immediately preceding taxable year "(if the private foundation was subject to the tax imposed by this section for such preceding taxable year)." A question arises when the allocation of the distribution to the undistributed income of the immediately preceding taxable year can occur. Is it (a) after there has been a final determination of tax liability under section 4942, (b) after a notice of deficiency is sent, (c) after the assertion of such liability upon field audit, or (d) merely because a private foundation is subject to the provisions of section 4942 whether or not a tax is in fact due under that section? Perhaps the phrase "subject to the tax" should be changed to "liable for tax."

It is not clear what purpose is served by the sentence appearing in section 4942(h)(2) in lines 23 and 24 on page 31 stating that "for purposes of this paragraph, distributions shall be taken into account in the order of time in which made." This raises the same questions noted earlier about the making of determinations otherwise than on an annual accounting basis.

Section 4942(h)(2) provides that in the case of any qualifying distribution which is not treated as made out of the undistributed income of the immediately preceding taxable year, the taxpayer may elect to treat any portion of such distribution as made out of the undistributed income of a designated prior taxable year or out of corpus. The only distribution that would not have been first charged to income of the immediately preceding taxable year will be undistributed income of the current taxable year. Thus, the foundation's election is only as to which of its items of undistributed income will remain subject to tax, namely, the undistributed income of a designated prior taxable year or of the current taxable year. It is not evident why this election has any significance since in any case the undistributed portion will continue to bear the 15 percent tax imposed by section 4942.

9. Section 4942(j)(3) defines an operating foundation. To be such, with the attendant advantages, it is provided in subparagraph (B)(i) that substantially more than half of the assets must be devoted directly to the exempt functions. There is a question as to the meaning of "substantially more than half." In some tax areas, even half is a substantial amount. What, then, is the meaning of substantially more than half? A more precise definition is needed. If two-thirds is intended, it should be stated.

10. Instead of describing assets "devoted directly" to the exempt activities, it would seem preferable to describe them as they are else-

where in the bill, i.e., as "used (or held for use) directly" in carrying out the activities. See for example, section 4942(e)(1)(A), page 27, line 8.

In section 4942(j)(3)(B)(ii), reference is again made (page 34, line 8) to "support" of the organization. As noted above, a definition of "support" is needed.

In section 4942(j)(3)(B)(ii) (page 34, line 11), reference is made to 5 or more "exempt" organizations. A more precise reference should be made to organizations exempt under some particular section of the Code. It is not adequate to refer merely to 5 or more exempt organizations which are *not* described in 4946(a)(1)(H). Is the phrase "exempt organizations" intended to mean any organization exempt under any of the provisions of section 501(c)?

11. In numerous places in the bill the Secretary or his delegate is directed to determine various matters relevant to the determination of the tax imposed by section 4942.

On page 27, line 19, the Secretary or his delegate is directed to prescribe regulations setting forth the times and manner of determining the fair market value of a foundation's assets other than securities for which market quotations are readily available. Regulations already exist on the subject of valuation for a variety of purposes. A further valuation regulation hardly seems warranted.

On page 28, line 1, the Secretary or his delegate is directed to proclaim an applicable percentage figure to use in determining the minimum investment return and is directed to produce a rate that bears a designated relationship to the 5 percent figure that appears in the statute. The designated relationship involves a determination of money rates and investment yields which the Secretary is being asked to compute.

On page 30, line 21, the Secretary or his delegate is directed to prescribe the terms and conditions upon which the set-asides can be established and on page 31, line 2, the Secretary must be satisfied that the set-aside will be paid out within the specified period. Also, on page 31, line 9, the Secretary or his delegate for good cause shown can extend the payout period.

On page 32, line 10, the Secretary or his delegate is directed to prescribe by regulations the basis upon which the taxpayer may elect to treat a portion of a distribution as being made out of undistributed income of a designated prior taxable year or out of corpus.

On page 33, line 17, the Secretary or his delegate is directed to determine what time is reasonable and necessary in which to permit a distribution of undistributed income to be made.

It is submitted that the administration of section 4942 places an

undue administrative burden upon the Secretary or his delegate. Means should be provided to be more specific in the statutory language, to avoid the necessity of involving the Secretary or his delegate in so many policy determinations.

Bill p. 34-42, § 101(b) [IRC new § 4943]
Taxes on Excess Business Holdings

1. Section 4943(c)(4)(B) and (C) provides for 2- and 5-year interim dispositions of excess business holdings. Consideration should be given to the necessity for such provisions. They serve only to evidence the good faith of the foundation in commencing to comply with the 10-year grace period for divestiture of its excess business holdings. Furthermore, in the case of closely held stock it may not be possible to dispose of 10 percent of the excess holdings at a fair price, if at all.

The 2-year 10-percent rule may be avoided upon proof of hardship coupled with proof that control of ten percent of the excess interest will be exercised by persons other than the foundation or a disqualified person. By whom would such control be exercised? To whom can a fiduciary properly transfer the right to control a portion of its investment? What is accomplished by establishing third-party control of such a small portion of the stock?

2. Section 4943(c)(4) provides a 10-year grace period for disposition of excess business holdings held on May 26, 1969. Paragraph (5) provides that in the case of holdings acquired by will, the 10-year grace period will commence to run on "the date of acquisition by will" instead of May 26, 1969, if the will is executed on or before July 28, 1969 and if the terms thereof are in effect on July 28, 1969 and at all times thereafter.

The meaning of the language "under the terms of a will executed on or before July 28, 1969, which are in effect on such date and at all times thereafter" is not clear. It would seem that the terms take effect only upon the death of the testator. If in fact the controlling date is the date of execution of the will, then the 2-, 5- and 10-year periods may be lost because the death of the testator may occur after the expiration of such periods. The effect of the execution of a codicil is not clear. Will it destroy the July 28, 1969, date if the original will was executed on or before that date?

3. Section 4943(c)(3) attempts to equate non-corporate business holdings with corporate holdings. It provides that in the case of a partnership or a joint venture, a "profits interest" shall be substituted for "voting stock" and "capital interest" shall be substituted for "non-voting stock." As a catch-all, the bill provides that in any other case

"beneficial interest" shall be substituted for "voting stock." Whether a foundation's interest in a partnership is in profits or in capital is not determinative of the nature or extent of its voice in partnership affairs. It would seem more appropriate in this context to equate general partnership interests with voting stock and limited partnership interests with non-voting stock.

Bill pp. 42-43, § 101(b) [IRC new § 4944]
Investments Which Jeopardize Charitable Purpose

Section 4944 states that if a private foundation invests any amount in such a manner as to jeopardize the carrying out of its exempt purposes, a tax is imposed on the making of such investment equal to 100 percent of the amount so invested.

The House report, part 1, p. 31, states that the purpose of the new section is to apply the same basic tests to the investment of assets as presently are applied to the investment of income under section 504 (a) (3) although the latter section would merely cause loss of exemption instead of the 100 percent tax as currently proposed. Present section 504(a) (3), after which section 4944 is patterned, has not been amplified by regulations since its enactment nineteen years ago.

The tax may be unduly harsh. For example, if the foundation invests $1,000 of its funds in a way which is deemed to jeopardize the carrying out of its exempt purpose and if the investment declines in value to $500, the proposed new tax would require payment of $500 from the foundation's other assets. By hypothesis, only $500 remains from the imprudent investment but there will be a tax of 100 percent of the original $1,000 investment.

The House report, part 1, p. 31, states that "it is expected" that the 100 percent tax could be avoided where a State attorney general exercises his power to preserve the foundation's assets for charity by appointing new trustees, by requiring the distribution of the offending foundation's assets to a public charity, "or by taking other appropriate action." It is not apparent, however, where that relief is provided.

Bill pp. 47-51, § 101(b) [IRC new § 4946]
Definitions and Special Rules

1. In the case of excess business holdings, section 4943, consideration should be given to excluding from the term "substantial contributor" members of the substantial contributor's family (and corporations, etc. controlled by them) if the substantial contributor made his contribution more than 10 years prior to the questioned transaction or activity. Likewise, for the purposes of section 4941, perhaps a substantial contributor

should cease to be such after 10 years. It is questionable whether members of the family of an individual donor, dead perhaps 30 years, should be treated as per se disqualified persons where the family's own involvement in recent years would not make them in their own right disqualified persons.

2. The term "substantial contributor" is defined in section 507(b)(2) and section 4946(a)(2). It is used not only in connection with the excise tax provisions but also in connection with the requirement of filing public information returns (§ 6033(b)(5)), making the names of such persons part of the return. It is not known whether a separate standard is to apply or whether failure to cross-reference the definition was intended to allow the use of a higher or lower figure (other than $5,000) which may be prescribed by regulations.

3. With respect to the attribution rules contained in section 4946, attention is invited to the position of the American Bar Association as to the desirability of uniformity and simplicity in the attribution rules throughout the Internal Revenue Code. (*Tax Lawyer,* Vol. XXI, No. 4, pp. 921-930; *Tax Lawyer,* Vol. 22, No. 3, pp. 449-450; ABA Reports, 1969, Vol. 94, p. —). The rules set forth in section 4946 are not consistent with this position.

4. In the definition of a disqualified person for purposes of section 4943 (§ 4946(a)(1)(H)(i)) reference is made to a private foundation "which is effectively controlled (directly or indirectly)." Contrast this with section 4942(g)(1)(A) which refers to an "organization controlled (directly or indirectly)." Is there a difference between "controlled" and "effectively controlled"?

Bill pp. 56-57, § 101(c) [IRC new § 6684]

Assessable Penalties for Repeated, or Willful and Flagrant, Acts Under Chapter 42

1. The taxes imposed under chapter 42 are, in reality, penalty taxes, in most cases, particularly in the case of taxes imposed after the expiration of the correction period. In such instances this additional penalty seems too onerous both in circumstances of application and amount. It seems incongruous for this penalty to be twice the civil fraud penalty, and to be imposed in addition thereto. Section 101(f) of the bill and section 101(j)(50) of the bill make the civil fraud penalty applicable to chapter 42 taxes. It would seem that the 50 percent civil fraud provision is adequate for chapter 42 taxes.

2. The 100 percent penalty provision has several defects. The penalty is imposed whenever a person has "theretofore been liable for tax" under chapter 42. Under chapter 42, a tax is imposed on self-dealing;

another tax is imposed on failure to distribute income; another tax is imposed on excess business holdings; another tax is imposed on investments which jeopardize charitable purposes; and other taxes are imposed on certain expenditures which are considered improper for a private foundation. The effect of this penalty, as now written, is to impose a penalty for a tax on one activity by reason of one having previously been liable for a tax on another activity. At the very least, the words "such section" should be inserted in line 22 on page 56 of the bill in place of the words "such chapter." The penalty is also imposed if the act or failure to act is both willful and flagrant. The word "flagrant," which is unknown in the tax law, has many connotations. Its use would undoubtedly result in much litigation to interpret its meaning in this context.

Bill pp. 57-60, § 101(d) [IRC amended § 6033(a) and (b)]
Information Returns of Exempt Organizations

1. The "efficiency" standard of section 6033(a)(2) undoubtedly contemplates excusing small organizations from filing an annual return. It would be preferable if a statutory exception were provided for organizations with less than $5,000 in gross receipts or assets excusing them altogether. Such a provision is appropriate because the potential for abuse in small organizations is minimal; the organizations probably rely on volunteer assistance (not necessarily trained in accounting procedures); and the information would probably be of interest to few, if any, members of the public.

2. The amendment to section 6033(b)(5) would appear to be an unnecessary invasion of the privacy of charitably inclined individuals. It might serve to curtail donations. It appears to serve no substantial tax purpose. It might be well to provide that contribution information would be required only for use by the Internal Revenue Service in its enforcement program for cross checking individual and corporate tax returns with exempt organization information returns. (*Cf.* Treas. Reg. § 1.170-1(a)(3)(iii) and § 1.6033-1(a)(4)(i), and instruction 17, Form 990-A.)

It may be desirable to require an information return to be filed upon the termination or liquidation of an exempt organization similar to that now required for non-exempt corporations under section 6043.

Bill pp. 60-61, § 101(e) [IRC new § 6104(c)]
Publicity of Information Required by Certain Exempt Organizations

Section 6104(c)(1)(C) provides for furnishing any information relevant to "any determination under State law." This provision seems

unduly broad, as it would permit the Internal Revenue Service to furnish information relevant not only to the organization, but also apparently to its donors, officers, donees, etc. To that extent it constitutes an extension of present rules applicable to publication of information by the Internal Revenue Service. It would seem appropriate that the statute itself provide that the disclosure of information be relevant only to determinations under State law that relate to the satisfaction of its charitable purpose by the organization or its liability under State tax laws.

Bill p. 62, § 101(f) [IRC amended §§ 6211(a), 6212(c)(1), and 6213]

Petition to Tax Court; Deficiency Procedures Made Applicable

Sections 6211(b)(2), 6212(a), 6212(b)(1), and 6213(a), and the title of subchapter B of chapter 63, subtitle F of the Code should be amended so as to reflect the inclusion of chapter 42 taxes.

A provision should also be added to give the Tax Court jurisdiction in the case of penalties imposed under section 6652(d) (penalties in connection with failure to file an exempt organization information return).

Bill pp. 63-64, § 101(g)(2) [IRC new § 6501(c)(7)]

Termination of Private Foundation Status

Section 101(g)(2) provides that "In the case of a tax on termination of private foundation status under section 507, such tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time."

This appears to be a provision relieving the Commissioner of the necessity of assessing a tax prior to its collection, which would have ramifications throughout the Internal Revenue Code. It would also seem to prohibit the application of *any* statute of limitations to such collection. The only similar provisions are contained in sections 6501(c)(1) (relating to false returns); 6501(c)(2) (relating to willful attempt to evade tax); and 6501(c)(3) (relating to failure to file a return). The American Bar Association has recommended an eight-year limitation in the case of fraudulent returns and the non-fraudulent failure to file returns. (ABA Reports, 1956, Vol. 81, p. 397; ABA Reports, 1961, Vol. 86, pp. 123, 125, 329-30).

Section 507 is a confiscatory tax equal to prior net tax benefits to the foundation and its substantial contributors or, in the case of lack of records, the net value of the foundation assets. The tax under section 507 can be imposed only upon (1) voluntary termination by the founda-

tion of its status by notification to the Secretary of the foundation's intent to terminate (section 508(d)), or (2) termination of foundation status by the Secretary for "willful repeated acts (or failures to act)" or "a willful and flagrant act (or failure to act)." (Section 508(e)).

In either case the Secretary would have actual notice of the termination and could assess the tax within the normal three-year limitation period.

In the event that a limitation period is placed upon the assessment of tax under section 507, an appropriate amendment should be made in proposed section 6501(c)(7) to provide that in the event a tax is imposed under section 507(a), by virtue of termination of status under section 508(d) or (e), the tax may be assessed or action for collection without assessment may be begun within the three years after the date of notification to the Secretary of voluntary termination of status under section 508(d), or notification by the Secretary of termination of status under section 508(e).

It would also be necessary to amend section 6511 relating to limitations on credit or refund, to provide that a claim for credit or refund of a tax imposed under section 507 must be filed within the period prescribed by section 6501(c)(7) for the assessment of a tax.

Also, amendment of other chapters of the Code would be essential if chapter 42 is enacted. Chapters requiring special attention in this connection are chapter 64 (Collection), chapter 65 (Abatements, Credits and Refunds), chapter 70 (Jeopardy, Bankruptcy and Receiverships), and chapter 71 (Transferees and Fiduciaries).

Bill p. 64, § 101(g)(3) [IRC new § 6503(h)]
Suspension Pending Correction

Although it would seem proper to allow an extension to be made to encourage the correction of improper action, either by the foundation or by action of a State, the proposed section would allow the Secretary to extend the period for *any time* without limit, without the consent of the taxpayer. This would seem to be unduly broad. It is suggested that any extension under this section, without the consent of the taxpayers, should be limited to a specified period of time, such as one year.

Bill pp. 65-66, § 101(i) [IRC new § 7422(g)]
Civil Action for Refund

Contrary to present excise tax refund requirements, proposed section 7422(g)(1) requires that chapter 42 excise taxes must be paid in full (as to the initial or additional tax) before commencing a suit for refund. There should be no requirement that both the tax on the

disqualified person (§ 4941(a)(1)) and any participating foundation manager (§ 4941(a)(2)) be paid in full to test the correctness of the assessment.* It is unclear whether, in joint assessments, both must join in the refund suit. It should be clear that a satisfactory partial payment by one or the other should suffice. Since the standard of liability as to each participant is distinct (though the transaction is bilateral), the foundation manager should not be required to join in the suit.

Since some of the taxes may be assessed for transactions continuing over a period of years in the taxable period, the taxpayer should be given the right to pay tax for only one year in the taxable period in order to contest the tax. *Steele v. United States*, 280 F.2d 89, 91 (8th Cir. 1960). The Government would protect its interests by filing a counterclaim as to the remaining tax in dispute.

Bill pp. 66-80, § 101(j)(43) [IRC new § 6214(c)]
Technical, Conforming, and Clerical Amendments

Paragraph (43), page 76 of the bill, adds a new subsection (c) to section 6214. This new subsection may create an ambiguity. It appears that the intent of this amendment is to extend the present income and gift tax jurisdictional provision in present section 6214(b) to chapter 42 taxes. The basic problem appears to be due to the use of the phrase "any other tax has been overpaid or underpaid" at the end of new section 6214(c) in lieu of the phrase "the tax for any other year has been overpaid or underpaid." It would seem that consistency of draftsmanship and intent would require that lines 4 and 5 of paragraph (43) at page 77 of the bill be amended to read "jurisdiction to determine whether or not the taxes under chapter 42 for any other period, act, or failure to act have been overpaid or underpaid."

In subsection 101(j)(50) of the bill the word "overpayment" should be changed to "underpayment."

SUBTITLE B—OTHER TAX EXEMPT ORGANIZATIONS

Sec. 121. Tax on Unrelated Business Income

Bill pp. 85-86, § 121(a) [IRC amended § 511(a)(2)(A) and § 511(b)(2)]
Organizations Subject to Tax

It is suggested that there be a parity between exempt corporations and exempt trusts with respect to the rate of tax imposed upon unrelated business income. It is recommended that the rate of tax applic-

* To the extent that *Flora v. United States*, 357 U.S. 63 (1959), on rehearing, 362 U.S. 145 (1960), which involved income tax, suggests a contrary rule, it is the position of the American Bar Association that this decision should be overruled by legislation. (ABA Reports, 1961, Vol. 86, pp. 123, 333-331).

able to section 501(c) trusts should be the rate imposed on corporations under section 11, rather than the individual rates presently imposed upon such trusts.

Bill pp. 87-89, § 121(b)(1) [IRC amended § 512(a)(3)]
Special Rules Applicable to Organizations Described in Section 501(c)(7), (8), (9), or (10)

Under section 512(a)(3)(A), as amended, deductions directly connected with "exempt function income" will not be deductible. This may be inconsistent with the allowance under present Treasury regulations and under the proposed section on "advertising," of a deduction for the editorial costs to arrive at the "net" revenues from advertising. If this is an ambiguity, it should be corrected.

Gains from the sale or exchange of property (used to carry out exempt functions) should not be taxed as they apparently would be under this proposal. See *Mill Lane Club, Inc.*, 23 T.C. 433 (1954); *Cf.* Rev. Rul. 66-149, 1966-1 C.B. 146.

To the extent that charitable and educational expenditures are made from the investment income of social clubs or of organizations exempt under section 501(c)(8), it might be desirable to make such distributions deductible in determining net investment income.

Bill pp. 90-93, § 121(b)(2) [IRC amended § 512(b)(4), (12), (15), and (16)]
Modifications

With respect to the taxability of certain income from controlled corporations, it may be desirable not to define the control requirements as the statute now does by reference to section 368(c) of the Code. Section 368(c) refers to "ownership of stock." A membership organization, organized under a non-profit statute, may not be treated on an equal basis even though it pays rent to its exempt parent.

It may be appropriate to consider a transition rule postponing the effective date of the statute with respect to so-called controlled corporations.

Bill pp. 93-94, § 121(c) [IRC amended § 513(c)]
Advertising, Etc., Activities

If this provision is intended to codify present Treasury regulations relating to advertising profits derived from publications of exempt organizations, it should be appropriately limited. As drafted, the statute would tax *any* activity of affected organizations without regard to regularity, profit motive, or continuity.

The proper allocation of expenses (direct and indirect) between taxable advertising and non-taxable activities of an affected exempt

organization may be difficult. House report, part 1, p. 50, states that the Secretary or his delegate will prescribe regulations with respect to such allocation. It is recommended that guidelines for such allocation be set forth in the statute.

Bill pp. 94-107, § 121(d) [IRC amended § 514]
Unrelated Debt-Financed Income

This provision subjects debt-financed income of an exempt organization to tax. The purpose of this provision is to overrule the *Clay Brown* case* and eliminate the ability of an exempt organization to purchase a business on a "bootstrap" basis by paying for it out of earnings which are not subject to tax. This provision is similar to a recommendation heretofore made by the American Bar Association except that it applies the unrelated business tax to debt-financed dividends, interest, and capital gains. (Bulletin of Sec. of Taxation, Vol. XX, No. 4, p. 69; Tax Lawyer, Vol. XXI, No. 3, p. 457; ABA Reports, 1968, Vol. 93, p. —). It is believed that the extension of the debt-financed tax to these sources of income is unnecessary to correct the basic abuses involved in bootstrap transactions. There are also other provisions in the bill relating to neighborhood land and churches which are outside the scope of the recommendation of the American Bar Association.

Bill pp. 108-109, § 121(f) [IRC amended § 7605(c)]
Restrictions on Examination of Churches

This provision restricts the right of the Internal Revenue Service to conduct an audit of a church unless the Secretary or his delegate, who may be no lower than the principal Internal Revenue regional officer, notifies the church that he believes it may be engaged in an unrelated trade or business. This difference in audit procedure with respect to churches appears to introduce an unnecessary complication.

TITLE II—INDIVIDUAL DEDUCTIONS

SUBTITLE A—CHARITABLE CONTRIBUTIONS

Sec. 201. Charitable Contributions

Bill pp. 112-114, § 201(a)(1) [IRC new § 170(b)(1)(D), (E), (F) and (G)]
Unlimited Charitable Contribution Deduction

This provision repeals the unlimited charitable deduction. Transitional rules provide for a five-year phaseout. The "transitional income percentage" of adjusted gross income is the amount below which charitable contributions cannot reduce taxable income. The "transitional deduction

* *Commissioner v. Clay B. Brown*, 380 U.S. 563 (1965).

percentage" is the percentage of taxable income which must consist of charitable contributions and taxes in order for an individual to be eligible for the "unlimited deduction." As the deduction percentage decreases, the income percentage increases, and by January 1, 1975, both percentages will be 50 percent.

The provisions for limiting tax preferences (LTP) and allocation of deductions (AOD) would appear to be applicable to taxpayers who qualify for the unlimited charitable deduction during the phase-out. If this is so, and if the phase-out provisions also apply, then the interaction of the two should be considered.

Present section 170(g) precludes section 170(b)(5) carryovers by taxpayers claiming the unlimited charitable deduction. While appropriate under existing law, interaction of transitional rules of new section 170(b)(1)(E), (F) and (G) may make such carryovers desirable; i.e., during the 5-year transitional period a taxpayer who has qualified for the unlimited deduction under section 170(b)(1)(D) may have that deduction partially reduced if his taxable income is less than the transitional income percentage of his adjusted gross income.

Bill pp. 114-116, § 201(a)(1) [IRC new § 170(b)(1)(H) and (I)]

Denial of Deductions

This section changes present law by disallowing a deduction for a gift of an income interest to charity. Where a donor transfers his entire interest in property irrevocably and retains no reversionary interest, there is no sound reason for disallowing a deduction for a gift of an income interest to charity. The "double tax benefit" argument, House report, part 1, p. 61, proves too much. It applies with equal force to an outright gift to charity. Here, too, the donor will receive a tax benefit from excluding the income from his return (for the rest of his life) but will nevertheless receive the benefit of a tax deduction for the full value of the property given to charity. Furthermore, there is no basis for differentiating between a gift to charity of an income interest and a remainder interest. Indeed, the charity receives the benefit of an income interest immediately but must wait to receive the benefit of the remainder interest. In short, there is no basis to distinguish between an outright gift, a gift of an income interest or a gift of a remainder interest.

Bill pp. 116-118, § 201(a)(1) [IRC new § 170(b)(1)(J)]

Special Limitations on Contributions of Appreciated Property

Section 201(a)(1) adds a limitation of 30 percent of the contribution base in the case of gifts of appreciated property not covered by section 201(c) of the bill (IRC amended § 170(e)).

1. This provision would appear to conflict with the stated purpose of the increase from 30 percent to 50 percent in the percentage limitations on individual deductions. The House report, part 1, p. 52, states that the increase to 50 percent was desirable to counterbalance the financial effect on charities of the repeal of the unlimited charitable deduction. Denying gifts of appreciated property eligibility for the 50 percent limitation significantly undercuts the effect of the increase to 50 percent.

In any event, the proposal in its present form could have an unintended harsh result in some cases. The limitation applies to the full value of the contributed property and not just to the appreciation element. Thus, the deduction of a gift of stock worth $100,000 would be limited to 30 percent whether the donor's basis was $1.00 or $99,999; however, if his basis were $100,000 the 50 percent limit would apply. If there is a special 30 percent limitation for such property, logically the limitation should apply only to the appreciation, with the basis of the property being eligible for the additional 20 percent allowance as provided by section 170(b)(1)(B).

2. It should be pointed out that the House report, part 1, p. 52, incorrectly describes the new limitation. Specifically, the suggestion that the 30 percent limitation would apply to all contributions of appreciated property is incorrect. Such limitation is actually only a maximum; in the case of gifts to private foundations the 20 percent limitation of section 170(b)(1)(C) would control.

3. The new section also creates a separate carryover category of excess contributions of appreciated property which is not explained in the general explanation of the bill, and appears to be incorrectly explained in the technical explanation of the bill on page 33. The example there given states that where there is an excess of contribution of appreciated property and also an excess of cash contributions by reason of the 50 percent limitation, *all* of the excess must be carried over "to any contributions of appreciated property in the following years." There is no reason why excess cash contributions should have to be added to excess appreciated property contributions in determining subsequent years' limitations on contribution of appreciated property.

Bill pp. 119-120, § 201(a)(3) [IRC new § 170(b)(6)]
Contribution Base Defined

If LTP and AOD are to be applied to charitable contributions of individuals, the allowable tax preferences should be included in the contribution base as section 201(a)(3) proposes. However, as presently drafted, it appears that computation of the base may produce in some instances circular computations. For example, the contribution base equals

adjusted gross income plus allowable tax preferences as determined under section 277(c)(2) (p. 120, line 5). Allowable tax preferences equal tax preferences as determined under section 84(c) minus those that are included in gross income under section 84 minus $10,000 (§ 277(c)(2), p. 175, lines 12-20). Tax preferences include deductions under section 170 which are attributable to the appreciation and which are allowable for the taxable year (§ 84(c), p. 166, line 8). Therefore, if appreciated LTP property is given to public charities, there can be instances where in order to determine the amount deductible under section 170 one must know the amount of tax preferences, and in order to determine the amount of tax preferences one must know how much is deductible under section 170.

Bill pp. 120-121, § 201(a)(3) [IRC new § 170(b)(7)]
Disallowance of Deduction in Certain Cases

During the transition period, this provision creates unintended hardships on existing section 501(c)(3) organizations. To preclude disallowances for charitable contributions paid in taxable years beginning after December 31, 1969, section 170(b)(7)(A) requires the donee section 501(c)(3) organization to be exempted from or to have complied with the provisions of section 508(a), (b), or (g). Subsection (b) of section 508 applies to existing charitable organizations and requires, unless exempted, notification of the Secretary pursuant to his regulations that it is not a private foundation. The effect is to preclude a charitable contributions deduction to certain existing section 501(c)(3) organizations until the Treasury issues regulations. To avoid these unfortunate results, references should be deleted to section 508(b) in the following places: lines 14 and 18, p. 120; lines 21 and 23, p. 130; line 24, p. 132; line 1, p. 133.

Bill p. 121, § 201(a)(3) [IRC new § 170(b)(8)]
Denial of Deduction in Case of Contribution of Partial Interest in Property

This section disallows a charitable deduction for contributions of partial interests in property. It would seem to be broader than the House Committee's general explanation of the reasons for this change. Deductions for non-trust charitable contributions of less than entire interests in property are denied unless otherwise permitted under section 170 for gifts in trust (i.e., under the annuity or unitrust provisions in section 170(b)(1)(H) (line 17, p. 114) or section 170(h) (line 15, p. 127). The effect may be to deny contribution deductions for outright gifts of

undivided interests in property as well as of legal life estates or remainders unless all other interests in the property also are contributed.

The provision is effective for contributions made after April 22, 1969. This is unwarranted, particularly since the Treasury's proposals issued on April 22 gave no indication of the breadth of disallowances caused by the proposal.

Bill pp. 122-125, § 201(c)(1) [IRC new § 170(e) and § 83]
Charitable Contributions of Appreciated Property

1. If the abuse sought to be corrected by this section occurs primarily in connection with charitable contributions of ordinary income property, such as inventory, it should be noted that section 83 requires recognition of gain in a number of situations not falling within the area of such abuse. For example, the recognition requirement would apply to gifts of works of art, even to public museums. Further, application of the proposed general rule to future interests of all types of property produces an effect that goes far beyond eliminating the most flagrant means of avoiding taxes. It is suggested that section 170(e) apply solely to gifts of ordinary income property.

2. We have the following comments regarding the proposed statutory language of these sections.

It is noted that section 170(e)(3)(B) (p. 124, line 15), requires distribution of *all* gifts of appreciated property. This will mean, as a practical matter, that a private foundation subject to this requirement will have to make corpus distributions in an amount equal to 100 percent of all contributions of property received. Neither the bill nor the House report indicates how the 100 percent is to be determined vis-a-vis increases or decreases in value of the contributed property between the dates of contribution and distribution.

The intent of section 83(b) (p. 126, lines 2 and 3) is unclear. We suggest that the reference to "section 170(e)(1)" in line 2 should be to "section 170(e)(3)." In proposed section 170(e)(3)(B) (p. 124, line 10), "first year" should read "first taxable year."

Bill pp. 126-127, § 201(d) [IRC amended § 1011]
Bargain Sales to Charitable Organizations

There seems to be no valid reason to differentiate between bargain sales to charities and bargain sales to other donees. Where the donor is willing to make a gift to charity of the difference between the fair market value and the purchase price, he should receive the full tax benefit. For example, taxpayer A gives securities worth $50 with a basis of zero. He receives a deduction for the entire $50 and has no recognizable gain,

assuming new section 170(e) does not apply, and he would not be required to include any amount as income. On the other hand, if taxpayer B sells property to a charity at his cost of $50 at a time when it is worth $100 he would have a $50 charitable deduction and would also be required to report $25 of gain. We believe such a distinction in tax treatment is not justified.

In any event, it should be made clear to what extent, if any, the portion of the bargain sale treated as a gift falls within the ambit of section 170(b)(1)(J) (applying a 30 percent limitation on contributions of appreciated property) and section 170(e) (p. 122, line 25) (relating to contributions of appreciated property). It would appear that the rules of those sections would be applicable to the gift portion of the sale.

Bill pp. 127-128, 135-137, § 201(e) and § 201(i) [IRC new § 170(h) and § 664]

Charitable Remainder Trusts

The basis for these provisions, the argument that the value of the remainder can be wiped out, is questionable because: (i) trustees are bound by state law to protect the remainderman's interest, (ii) State attorneys-general increasingly exercise supervision, (iii) the remainderman itself can protect its interest, and (iv) even with a unitrust or annuity the remainder could be destroyed by bad investment.*

1. The provisions of this section are applicable to transfers in trust made after April 22, 1969, but the provisions of section 664 defining "charitable remainder annuity trusts" and "charitable remainder unitrusts" are not effective except with respect to transfers in trust made after date of enactment of the bill. This would appear to create a hiatus between April 22, 1969, and the date of enactment of the bill. The difference in effective dates also creates a severe problem for draftsmen during this interim period since even if the effective date provisions were to be modified so as to permit a deduction for the gift of a remainder interest to a trust which would otherwise qualify under section 664, if made after April 22, 1969, and prior to date of enactment, such a trust would probably not qualify for unlimited deduction of amounts set aside permanently for charitable purposes under section 642(c) of the existing law.

2. The retroactive date of April 22, 1969, is inequitable. The bill goes beyond the proposals submitted by the Treasury to the House Ways and Means Committee on that date. Donors, on April 22, 1969, were not put on notice of the requirements for obtaining a charitable deduc-

* See, *infra*, pp. 26-31, for comment on estate and gift tax deductions for charitable remainder trusts.

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tion with respect to contributions of remainder interests. It is quite likely that many charitable remainder trusts have been established after April 22, 1969, in ignorance of the proposed new rules.

Bill pp. 128-130, § 201(f) [IRC amended § 642(c)]
Charitable Contributions by Estates and Trusts

The proposed amendment to section 642(c) is consistent with the other proposals contained in section 201. However, we suggest that transitional rules be added to cover existing trusts and estates, the governing instruments of which were presumably drafted without reference to the unitrust or annuity trust concept. We also suggest that consideration be given to adding a provision for reformation of instruments if possible, as well as a provision to have cases where the executor or trustee would make a current payment to charity, but for circumstances beyond his control, such as uncertainty as to the identity of the charity and charitable beneficiary or as to amounts available for payment because of obligations chargeable to gross income.

It is also suggested that the words "trustee" and "administrator" used in line 21, page 28 of the bill be changed to "fiduciary." The latter term is defined in section 7701(a)(6) as including "executor" as well as administrator and trustee.

Bill pp. 130-135, § 201(h) [IRC amended § 2055 and § 2522]
Estate and Gift Tax Deductions for Income Interests, Charitable Remainders or Other Partial Interests in Property.

We see no reason why either a charitable income interest or a charitable remainder after a normal life estate should not continue to be allowed as an estate or gift tax deduction. Aside from an outright transfer, such a remainder is the most common form of charitable bequest or gift. This garden variety of trust is customarily used by testators or creators of lifetime trusts who desire to leave all or a substantial portion of their estates to charity after making provision through life estates for one or more relatives (such as a surviving wife, sister, or unmarried daughter). This form of bequest predates the tax laws and, in our experience, has not been the subject of tax abuse.

The House report, part 1, pp. 58-59, describes two situations in which contributions deductions have been allowed for income tax purposes for gifts of trust remainder interests even though it was not probable that the gift would ultimately be received by the charity.* However, the report concedes that the contributions deductions "would not have been

* This is not, in our opinion, a fair characterization of the income tax decisions taken as a whole.

allowed in these situations if the probability of the charity receiving the specified interest were determined under the rules presently applied in the case of the estate tax." Therefore, the two examples cited in the report furnish no reason for changing the estate or gift tax law in this area.

The Internal Revenue Service and the courts have, in fact, carefully policed the estate and gift tax charitable deductions for income remainder or other partial interests in property. The value of the charitable interest is deductible only insofar as that interest is ascertainable at the time of death, and, hence, severable from the noncharitable interest by actuarial or other recognized techniques. Treas. Reg. § 20.2055-2(a). No deduction is allowable for a charitable transfer which is dependent on the performance of some act or the happening of some event unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. Treas. Reg. § 20.2055-2(b). The taxpayer has the burden of proving that, under these tests, the charitable interest is severable and not subject to defeat.

The proposed legislation makes no allowance for the often legitimate desire of the testator or settlor to make principal available to his wife or other income beneficiary in the event of future need or emergency. Powers to invade for emergency needs are extra precautions for the security of the income beneficiary, and are neither intended nor administered as devices to defeat the interest of the charitable beneficiary or remainderman. Under present law the charitable remainder is deductible if the executor can show that the power of invasion is subject to an ascertainable standard and that, by application of that standard, the possibility of invasion is sufficiently remote to be disregarded. The rules in this area have been developed in a solid body of decisional law. They are not the subject of abuse, and there is no good reason for discarding them.

The House report, part 1, pp. 58-59, questions the accuracy of the tables prescribed by the estate and gift tax regulations for valuation of remainders and other actuarial interests. These tables, adopted in 1952,* are based upon a mortality table derived from the 1940 census ** and interest at the rate of 3½ percent a year, compounded annually. Valuation of actuarial interests is, of course, an exercise in prediction, as to both mortality and interest yield. Nevertheless, it is a generally accepted —indeed, indispensable—valuation technique. We note that the House report contemplates the continued use of the present tables in valuing charitable remainders of annuity trusts and unitrusts.

* T.D. 5906, 1952-1 C.B. 155.

** Table 38, United States Life Tables and Actuarial Tables 1939-1941, United States Department of Commerce, Bureau of Census.

Life abounds in contingencies. The estate and gift taxes are founded on the principle that tax collection—like much other human activity—cannot await their resolution. These taxes are based upon valuations existing at the time of death or of gift. The actuarial art is an accepted element of this valuation process. It is used to separate complete from incomplete gifts, to value interests in property owned by the decedent, to measure reversionary interests in transfers made during life, to determine the marital deduction for remainder interests, and to measure the charitable deduction for remainders and other limited interests. Similar tables used by insurance companies in connection with the sale of commercial annuities and life insurance policies also govern the valuation of such properties for gift and estate tax purposes. There does not appear to be any indication that the use of actuarial methods of valuation in the charitable deduction area has been the subject of manipulation or that it has produced results that justify the radical legislative change proposed in the bill.

Even if we assume *arguendo* that allowance of estate and gift tax deductions determined by actuarial means should be circumscribed because charity may receive less than the actuarial forecast, we still find the proposed legislative classification unsatisfactory. One of the two types of trusts the bill would permit to qualify for the deduction, the annuity trust, is more of a "gambler's device" than the bulk of the trusts that the bill would disqualify. In the traditional trust to pay the income to an individual for life with remainder to charity, the charitable remainderman is assured of the trust principal, subject only to the prospect of its appreciation or depreciation in value and the prospect that the life beneficiary may outlive or predecease the predicted year of mortality for a person of his age. In contrast, an annuitant may exhaust the trust, so that charity would receive nothing although the bill would grant a substantial charitable deduction.* In our judgment the proposed statutory classification is not a sound one.

Congress should not arbitrarily restrict the estate and gift tax charitable deductions to two limited and novel forms of charitable remainder trusts. It would be unreasonable to force testators and settlors into the defined annuity or unitrust arrangements. To require the use of such arrangements would be unwise because of their lack of flexibility. The

* Under present law the courts have disagreed over the allowability of an estate tax charitable deduction for the charitable remainder of a trust following a private annuity where there is a significant possibility of exhaustion of the trust principal. Cases disallowing the deduction: *Moffett's Estate v. Comm'r.* 269 F.2d 738 (4th Cir. 1959); *Florida Nat'l Bank v. United States,* 1962-2 U.S.T.C. ¶ 12,082 (S.D. Fla. 1962). Cases allowing the deduction: *Schildkraut's Estate v. Comm'r,* 368 F.2d 40 (2d Cir. 1966), *cert. denied,* 386 U.S. 959; *Estate of Helen Stow Duker,* 18 T.C. 887 (1952).

proposed legislation is overly rigid and unduly restrictive and should not be enacted.

If sections 2055(e)(2) and 2522(c)(2) are enacted, consideration should be given to the following matters as they would affect charitable remainders:

a. The proposed definitions of a charitable remainder annuity trust and of a charitable remainder unitrust (Bill p. 136, line 16 through p. 137, line 15) would not permit a charitable deduction for the transfer to charity of an undivided fraction of a trust remainder, of a remainder in specific trust assets, of a charitable cash legacy out of a remainder, or of a charitable remainder subject to a private cash legacy. The definitions qualify a charitable remainder for deduction only if the entire remainder interest in the trust passes to charity. It is not unusual for a testator to divide a trust remainder into fractions for charitable and private remaindermen, or to charge small specific private legacies against an otherwise charitable remainder. There is no reason to deny deduction of whatever interest charity has in the remainder.

b. The definition of a charitable remainder annuity trust or unitrust would also eliminate any deduction for the charitable remainder of a trust, the income of which may, in the trustee's discretion, be distributed to a private individual, applied to his support, or accumulated. This type of trust may serve useful and important purposes where the income beneficiary is a minor, an incompetent, a person who is under a physical or mental disability, a spendthrift, or a person whose needs are so variable that predetermined fixed distributions would be unsatisfactory. We see no justification for penalizing the granting of such discretion to the trustee.

c. The proposed legislation would deny any estate tax charitable deduction for a charitable remainder following a legal life estate. Bequests of this variety are commonly used in some States, particularly for real estate or tangible personal property. It is also not unusual to designate a charity as the last taker under a life insurance settlement option or a commercial annuity contract. These charitable future interests do not lend themselves to the proposed annuity trust or unitrust treatment. They involve no element of tax avoidance and should remain eligible for the charitable deduction.

d. A trust may give a charity and a private beneficiary fixed shares of both the trust income and principal, the purpose generally being to avoid the extra expense and inconvenience of creating and administering separate trusts. An undivided interest in property may also be bequeathed or devised outright to charity. The proposed legislation

would, for no good reason, disallow any deduction for charity's undivided interest in such a trust, bequest or devise.

e. The definitions of a charitable remainder annuity trust and of a charitable remainder unitrust are too rigid in requiring that the payments to the private beneficiary be either for a term of years or for life. Charitable trust remainders may vest upon other events. For example, alimony trusts sometimes provide that the trust shall terminate in favor of charity upon the wife's death or remarriage. A deduction is now allowable for the charitable remainder (computed as though the wife's interest were a full life estate). The bill would deny that deduction.

f. The application of the definitions of a charitable remainder annuity trust and of a charitable remainder unitrust to the following three situations seem uncertain or unsatisfactory: (a) A testator (or the creator of an inter vivos trust) creates a trust for the joint lives of two individual beneficiaries with remainder to charity. (b) The creator of an inter vivos trust reserves the initial beneficial interest for life, gives his wife a secondary beneficial interest for life, and leaves the remainder to charity. (c) The creator of an inter vivos trust reserves a beneficial interest for life with remainder to charity. Situation (a) could not apparently qualify under the definition (which apparently permits only one life tenant); situation (b) could apparently qualify for estate tax purposes upon the creator's death but not for gift tax purposes initially; situation (c) would apparently not be subjected to annuity trust or unitrust treatment for gift tax purposes (since no interest passed from the decedent to a private person, as required at Bill p. 131, line 16, *et seq.*). Further thought should be given to the classification of these situations.

g. The proposed legislation would severely limit the types of assets that could be bequeathed or devised to, or invested in by, trusts with charitable remainders. Residences, jewelry, assets with low or fluctuating income and poor liquidity or marketability, and assets not having readily ascertainable fair market values would, for one reason or another, not easily be adaptable to annuity trust or unitrust treatment. This is another example of the undue rigidity of the legislative approach.

h. The proposed section 2055(e)(2) is in conflict with existing section 2055(b)(2), which specifically qualifies for the charitable deduction one type of trust having a private income beneficiary and a charitable remainderman. It is not clear which of these two conflicting statutory provisions is intended to override the other.

i. As is noted in the footnote on page 28, the courts have disagreed over the allowability of a charitable deduction under present law for the remainder of an annuity trust where there is a significant possibility that

the annuitant may consume the trust principal. It is not clear whether the court decisions disallowing such deductions are intended to be overridden by the proposed legislation. Is the legislation intended to qualify for the charitable deduction remainders of annuity trusts that may not qualify under existing court decisions, or does it simply add a new limitation to those now in effect?

j. The proposed definitions of a charitable remainder annuity trust and of a charitable remainder unitrust provide that the trust remainder must go to or for an organization or use described in section 170(c). (Bill p. 137, lines 1 and 14.) Section 170(c) describes the organizations to or for the use of which contributions deductible for income tax purposes can be made. There is an additional category of organizations to or for the use of which transfers deductible for estate and gift tax purposes can be made. These are religious, charitable, scientific, literary or educational corporations, trusts, etc., created or organized outside of the United States. (Compare sections 2055(a)(2) and 2522(a)(2) with section 170(c)(2).) Since outright gifts and bequests to or for the use of such organizations are deductible, there is no reason to circumscribe deduction of remainders more narrowly.

The estate tax amendments under discussion would apply to all decedents dying after the date of enactment of the bill and the gift tax amendments to all gifts made after April 22, 1969. These effective dates will cause a great deal of hardship and confusion. All existing wills and trusts of living persons will have to be reviewed and, if found to contain charitable remainder or income trusts or legal estates, will have to be changed, if possible. This will be a time-consuming task. Irrevocable or unamendable trusts cannot be changed, nor can the wills of testators who have lost their testamentary capacity or who die before the review of their wills can be completed. If these provisions are to be enacted, a substantial period of grace should be provided, as well as relief for existing irrevocable or unamendable trusts and existing wills of testators under disability.

Bill pp. 139-152, § 211 [IRC new § 1251]

Gain From Disposition of Property Used in Farming Where Farm Losses Offset Nonfarm Income

Under present law, a taxpayer engaged in farming is allowed to deduct in the year expended many of the costs of farming which in other trades or businesses would be treated as capital items recoverable only through depreciation or as a return of capital upon the sale of the property. This tax advantage increases, of course, with the tax bracket of the taxpayer.

1. The new section would modify the potential tax advantage under present law by requiring the taxpayer engaged in farming operations (with certain limitations) to maintain a bookkeeping record of his farming operations known as the excess deductions account, the purpose of which is to recapture farm losses on the sale or other disposition of farm property, gain from which under present law is taxable as long-term capital gain. In applicable cases, this would remove, or reduce, the tax advantage under present law of deducting costs against ordinary income and taxing the gain at capital gain rates.

We are not convinced that the problem which the section seeks to correct is sufficiently great to justify such complex legislation; but, if it is, then the approach reflected by the section is more acceptable than attempts to deal with it by other means, such as tampering with the timing of losses and gains as proposed in earlier legislative drafts in this area.

2. There are several technical features of the section which deserve comment.

Since as to farm land there is a 5-year recapture rule, there should also be a limit on the recapture period for other farm property. A ten-year period would seem adequate.

An unintended effect of the section in the case of a taxpayer who uses an inventory method of accounting for his livestock, but elects to expense the costs incurred in clearing land or for water and land conservation, is to subject such taxpayer to the provisions of section 1251(b)(4)(A) with respect to his livestock dispositions. After five years such land expenses are not included in computing the amount of recapture on the sale of land under section 1251(e)(5).

Section 1251(e)(4)(B) provides for the aggregating of all farm businesses into one business, apparently to determine whether a taxpayer comes within the exceptions of sections 1251(b)(2) and 1251(b)(4). However, as written, it applies to all of section 1251 and, for example, in the case of a taxpayer who first engaged in ranching and lost money and then engaged in the orchard business and made money, would prevent him from offsetting the loss against the gain. There is no apparent reason for this result, and the section should be modified accordingly.

With respect to the excess deduction account, it is clear in section 1251(b) that farm income in the second year will offset a farm loss in the first year, but it is not apparent that the reverse is true. This point should be clarified.

Section 1251(d)(6), relating to transfers to controlled corporations, appears to have an inadvertent omission in not including "securities" as well as "stock" as "farm recapture property." As written, it might permit a taxpayer to transfer farm recapture property to a controlled

corporation for stock and securities and then dispose of the securities and realize capital gain.

Gain realized by a taxpayer on farm recapture property which would be taxed as ordinary income under section 1245(a), as amended by section 212, should be applied to reduce the excess deduction account. Apparently this would not be the case under section 1251(e)(2). As long as ordinary income equals ordinary losses, section 1251 should have no application.

Bill pp. 152-153, § 212 [IRC amended §§ 1245(a)(2), 1245 (a)(3), and 1231(b)(3)]

Livestock

This section would subject livestock acquired by purchase to the same recapture provisions now applicable to other tangible depreciable personal property. Technically, the section presents one problem of importance to farmers.

At present, section 1231(b)(3) provides that livestock held for draft, breeding, or dairy purposes and held by the taxpayer for 12 months qualifies as section 1231 property, the net annual gain from which is capital gain, while the net annual losses are ordinary losses.

Section 212(b) of the bill would delay the start of the holding period until the time at which the animal would normally be used for one of the specified purposes. The stated purpose is more readily to distinguish between animals held for one of the specified purposes and those held for sale. As to hogs (and possibly some other animals), this requirement would result in an inadvertent inequity. An older sow will become so fat and expensive to feed that at the end of the delayed holding period she would have little economic or market value.

This difficulty may be solved by adopting an "actual use" test rather than a mere holding period requirement. Thus, the first sentence of section 1231(b)(3) might be amended to read:

> "Such term includes livestock which has been held by the taxpayer for 12 months and which during such period has been actually used for a period of six months by the taxpayer for draft, breeding, sporting, or dairy purposes."

Sec. 213. Hobby Losses

Bill pp. 153-154, § 213 [IRC amended § 270]

Hobby Losses

The proposed amendment to section 270 appears to contain so many technical deficiencies that we suggest that consideration be given to a complete redraft.

a. Although labeled as dealing with "hobby losses," section 213 of

the bill is much broader. Under the proposal, section 270 would be amended to apply not only to the traditional "hobby" but also to the normal profit seeking business and investment activities, including real estate operations, equipment leasing and oil and gas development and exploration.

b. The amendment to section 270 is not confined to losses incurred by individuals. The change in the caption of the section from "Limitation on Deductions Allowable to Individuals in Certain Cases" to "Limitation on Deductions in Certain Cases" confirms this despite the fact that the proposal is contained in Title III (Other Adjustments Primarily Affecting Individuals) of the bill.

The House report, part 1, p. 71 on the other hand, contains repeated references to activities carried on by an *individual*. This suggests that the section may have inadvertently been drafted more broadly than was intended.

c. In its present form, the proposal would extend to any business which incurred deductions in excess of gross income of more than $25,000 for any three of five consecutive years. If such losses occurred, the taxpayer would be required to rebut the statutory presumption that the business was not carried on with a "reasonable expectation of realizing a profit." Difficulties abound in determining what is a "reasonable expectation of profit." Would this rule preclude the losses of a high risk venture where the potential profit is substantial? Obviously, a slight chance of success might be reasonable where the potential profit is great.

d. The proposed new rules relate to the allowance of "*Items* attributable to an *activity*." "Items" is not a defined term. If it is not synonymous with deductions, it should be defined. If it is, "deductions" should be substituted for "items."

Furthermore, the term "activity" is not defined. Clearly, an "activity" would include an entire trade or business. Would it possibly include part of a trade or business? Would it include investment activities as well as personal transactions (for example, nonbusiness loans).

e. The proposal fails to indicate what "deductions" are attributable to an "activity." This deficiency could create problems.

f. The proposed section also fails to indicate whether it will be applied retroactively to the three years in which the excess losses occur or whether it applies only prospectively.

g. The proposal could result in a denial of business losses against future income from the same business. At least, in such a case, the taxpayer could be faced with the necessity of proving that the business was being carried on with a reasonable expectation of profit.

Sec. 221. Interest

Bill pp. 154-158, § 221 [IRC new § 163(d)]
Limitations of Interest and Investment Indebtedness

1. The statutory provisions do not make clear the order in which the three limitations ($25,000; net investment income; and long-term capital gains) are applied against the investment interest. The technical explanation indicates that the order is: first, $25,000, second, net investment income, and, finally, capital gains. The order of application is important since it affects the amount of the deduction and the consequent amount of the tax. This is especially significant if the ordinary income generated by sections 1245 and 1250 is also added to the list. Because of its importance, the order of application should be spelled out in the statute. Section 221(b) provides that the deduction for capital gains shall not exceed the sum of the net short-term capital loss and the amount of the investment interest allowable as a deduction under section 163(d)(1)(C). It should be made clear that the application of investment interest against long-term capital gains is applicable only after first applying the available investment interest deduction against the $25,000 allowance and the amount of the net investment income. The phrase "succeeding taxable year" in section 163(d)(2) should be changed to "succeeding taxable years."

2. The special rule in new section 162(d)(4)(C) provides that expenses allowable under section 162 must exceed 15 percent of rental income, or such income will be considered as investment income and not income from the conduct of a trade or business. There are undoubtedly many real estate investment situations which would constitute the actual conduct of a trade or business but which have deductions allowable under section 162 of less than 15 per cent of gross rental income. In computing such expenses the reasonable compensation of a proprietor for his services should be allowed as part of the expenses for purposes of computing the 15 percent.

3. In the definition of rents (section 163(d)(4)(C)) the references to a guarantee of a specified return or a guarantee in whole or in part against loss of income should be made more specific. Every lease pursuant to which a tenant is personally liable is a guarantee of the rent and indirectly a specified return of income. Where the lease contains escalation provisions it is arguable that there is a guarantee against loss of income or a guarantee of a specified return.

4. It should be made clear that a trade or business exists during the

period of the construction of a building, which when completed will be operated as a trade or business, so that the interest expense prior to the receipt of rental income will be deductible.

Bill pp. 158-165, § 231 [IRC amended § 217(a) and new § 82]
Deduction for Moving Expenses

1. Consideration might be given to the substitution of a "reasonable expenses" limitation for subparagraphs (C) and (D), such as that presently imposed (and to be continued) in the case of the expenses described in subparagraphs (A) and (B) of section 217(b)(1). There is no reason to assume that taxpayers would incur unwarranted expenses under subparagraphs (C) and (D) to any greater extent than under subparagraphs (A) and (B). In all four cases only actual out-of-pocket expenses will qualify for the deduction, and, in the case of taxpayers receiving reimbursements from their employers, the additional element of employer review provides a safeguard against abuse of this deduction.

2. Both present law and the proposal limit the available deduction to employees and do not provide for a deduction in the case of self-employed taxpayers. It would seem that need for relief for self-employed taxpayers is equally meritorious.

3. Subsection (b) of section 231 of the bill adds a new section 82 providing for the inclusion of moving expenses in income. This may be considered necessary because of the allowance of the deduction for the offsetting expenses. However, the Ways and Means Committee, at page 77 of its general explanation (House report, part 1, p. 77), states that the reimbursement would be subject to the withholding provision of section 3401(a). This conclusion would seem to be erroneous since section 3401(a)(15) provides that remuneration paid on behalf of an employee is not subject to withholding if at the time of the payment it is reasonable to believe that a corresponding deduction is allowable under section 217. It should be made clear that there should be no withholding on the reimbursement as to which it is expected there will be an offsetting deduction by the employee.

TITLE III—OTHER ADJUSTMENTS PRIMARILY AFFECTING INDIVIDUALS

SUBTITLE A—LIMIT ON TAX PREFERENCES AND ALLOCATION OF DEDUCTIONS

Sec. 301. Limit on Tax Preferences for Individuals, Estates, and Trusts.

Bill p. 166, § 301(a)(1) [IRC new § 84(c)(1)(A)]
Charitable Contribution of Appreciated Property

This subparagraph uses a new and undefined statutory term "appreciation in the value of property." It is assumed that the amount of such

"appreciation" would be measured in the usual manner for determining gain. Therefore, it is suggested that the term, "excess of fair market value over basis," be used. It is more precise and would avoid introducing a new and undefined term into the Code. Compare the manner in which the terms are used at bill p. 123, section 170(e)(1) and (2).

Bill p. 166, § 301(a)(1) [IRC new § 84(c)(1)(B)]
Accelerated Depreciation

1. In view of the revisions made in accelerated depreciation recapture in section 521 of the bill, there is considerable question whether this item continues to constitute a tax preference.

If accelerated depreciation is retained as an item of tax preference, the recapture rule under section 521 of the bill should be changed to provide for a correlative reduction of the amount recaptured as ordinary income on disposition. No language in new section 218 (providing for a mere increase in basis) has the effect of first reducing capital gains before reducing the amount taxed as ordinary income on disposition. A similar problem exists in new section 84(c)(1)(D) but appears to have been covered by new section 1251 (b)(3)(A) at bill p. 141. Needless to say, the treatment of these items as tax preferences will extensively complicate both the preparation and the audit of tax returns.

2. The reference to "amortization" in excess of the "depreciation deduction" under section 167(b)(1) (relating to the straight line method of depreciation) could possibly be construed as making the amortization of leasehold improvements a tax preference where the lease is for a term less than the useful life of the improvement. If this result was not intended, the language should be clarified.

3. In three separate provisions, section 301, new section 84(c)(1)(B), relating to tax preferences, section 452, new section 312(m), relating to earnings and profits, and section 521, new section 1250(b)(4), relating to rehabilitation expenditures, the bill establishes requirements, in addition to present section 1250(b)(1), that straight line depreciation be computed in respect of property on which depreciation for income tax liability purposes is computed by another method or a different life. In no two of the four provisions is the requirement exactly the same.

The concept of "straight line equivalent depreciation" presently finds use in the computation of class life required by the guideline test procedures set out in Revenue Procedure 62-21, where class life is determined by dividing the straight line depreciation into the total basis (see Rev. Proc. 62-21, Secs. 4.03 and 4.04, 1962-2 C.B. 434). The methods for computing the required straight line equivalent depreciation are set out in Question 58 of Appendix II of the Revenue Procedure (1962-2 C.B. 480-485).

The variation in the requirements will place an undue burden on an

affected taxpayer. Thus an individual who owns existing section 1250 property being depreciated in a group account under the double declining balance (DDB) or sum-of-the-years digits (SYD) method must make one computation for existing section 1250 purposes and another on an item basis for section 84 purposes. In addition, if he has elected to be tested by guideline procedures and uses the SYD method, he will be grouping assets by years of acquisition and will have to maintain a separate set of item records in order to make the necessary computations for section 84. This would appear to be true even though presumably he will be permitted to use a single group account for the section 1250 straight line computation. Furthermore, the average life used for the group computation may not be used for item computations unless the group consists of homogenous property.

It is suggested that the statement of and the rules for computation of straight line equivalent depreciation and the collateral consequences of the use thereof be uniformly stated to whatever extent is possible and that a consistent computation be indicated.

4. Section 84(c)(1)(B) is inequitable to the extent that it ignores the fact that over the greater part of the useful life of the individual property, straight line depreciation inevitably exceeds SYD or DDB depreciation in any given year. It seems only fair that such excess be treated as a negative tax preference which would reduce (but not below zero) the amount of disallowed tax preferences.

Bill pp. 169-170, § 301(a)(2) [IRC new § 218]
Adjustments for Disallowed Tax Preferences

Because of the progressive tax rates, it will be possible for a taxpayer to realize a greater tax reduction in one or more of the five carryover years than the increase in tax attributable to inclusion of disallowed tax preferences in gross income in the earlier taxable year. Conversely, a taxpayer having an amount of other taxable income in the later year less than the disallowed tax preference carried forward would receive a tax reduction in the later year significantly lower than the effective tax cost of the disallowed tax preference. In some cases the income averaging provisions of the Code would reduce the effective rate of the tax reduction attributable to the carryover adjustment below the effective tax cost of the disallowed tax preference in the earlier taxable year, but this would not be true in all situations.

This problem could be avoided in large part by providing that the carryover, instead of giving rise to a deduction, would give rise to a credit for taxes paid in the later year equivalent to the amount by which the preference year's tax was increased by reason of the amount for

which the bill now would allow a deduction. The suggested procedure would be similar to that now provided in section 1341(a)(5).

Bill pp. 173-180, § 302 [IRC new § 277]
Allocation of Deductions

The enactment of section 302 would adversely affect thousands of taxpayers, since the time-consuming adjustments called for by section 302 would apply, or figures would have to be assembled to determine whether they would apply, every year. Almost none of the figures necessary to make the adjustments required by section 302 are items already required to be shown on a tax return. They are largely items which, apart from section 302, would never have to be computed by the taxpayer (except in instances covered by section 301 of the bill, and some of the "preferences" described in section 302 are not included under section 301). In view of the universal desire for *simplification* of the tax laws, the desirability of a provision which will substantially complicate the return and recordkeeping requirements of a large number of taxpayers appears to be open to question.

For example, all taxpayers who may become subject to section 302 will have to keep records of all their income from tax-exempt municipal bonds. The additional computations and recordkeeping required under section 302 with respect to intangible drilling expenses, straight line depreciation, cost depletion, and the keeping of a separate set of farm books using the inventory method of accounting (including the taking of a beginning and ending inventory each year) introduce further complexities. As an example, in order to calculate for any year the amount of accelerated depreciation in excess of straight line depreciation (or, in the case of oil and gas wells, the amount of straight line depreciation which would have been allowed if the taxpayer had elected to capitalize intangible drilling expenses), the taxpayer will have to make a separate determination of the salvage value of each item (a determination which is not necessary under the 200 percent declining balance method) and if there has at any time been a change in useful life, he will have to recalculate straight line depreciation on a year-by-year basis from the time of his original acquisition of the property in question. Similarly, to determine the excess of percentage depletion over cost depletion, the taxpayer will have to determine the units of the natural resource extracted and sold during the year as well as the reserves at the beginning of the year. Reserves must be determined by an engineering report which must be updated to reflect changes affecting the estimate of reserves.

It is evident, therefore, that section 302 would require a number of exceedingly complicated computations and tax return entries (never

heretofore required) to be made by a large number of taxpayers, and would entail additional work by the Service in auditing, checking, and reviewing such additional computations and the evidence necessary to verify them. It would be a step in the opposite direction from the objective of tax and reporting simplification which much of the bill (particularly the proposed increase in the standard deduction) was designed to accomplish.

Bill p. 173, § 302(a) [IRC new § 277]
Allocation of Deductions—Application to Estates and Trusts

The heading of section 277 would indicate that it applies only to individuals, although the language of the section makes it applicable to any taxpayer other than a corporation, and the House report, part 1, p. 81, indicates that it was also intended to apply to estates and trusts. It is suggested that the heading be revised so that it is not misleading.

The application of the allocation provisions to estates and trusts is not clear. For example, assume that a simple trust has income and expenses as follows:

Dividends	$10,000
Tax-exempt interest	5,000
Capital gains	25,000
State income taxes	1,000
Actual distribution ($15,000–$1,000)	14,000

The Section 277 Fraction would seem to be computed as follows:

Numerator:		
Tax-exempt interest		$ 5,000
Capital gains deduction		12,500
		$17,500
Less: excluded		10,000
"Allowable tax preferences"		$ 7,500
Denominator:		
Dividends		$10,000
Taxable half of capital gain		12,500
		$22,500
Less state income taxes	$1,000	
Distribution deduction	9,000	10,000
Taxable income (without regard to § 277)		$12,500
Add back state taxes		1,000

"Modified adjusted gross income"	$13,500
Add "Allowable tax preferences"	7,500
	$21,000
Section 277 Fraction ($7,500÷$21,000)	35.7%
Disallowed deduction for tax (35.7% × $1,000)	$ 357

The effect on the taxable income of the trust and the beneficiary would seem to be as follows:

Recomputed taxable income of trust:		
Dividends		$10,000
Taxable half of capital gain		12,500
		$22,500
Less allowable state income taxes		643
		$21,857
Less: Distribution deduction		
Ordinary income	$10,000	
Allowable deduction	643	9,357
Taxable income of trust		$12,500
Taxable income of beneficiary		$ 9,357
Non-taxable income of beneficiary		4,643
Total distribution		$14,000

However, further clarification of the impact of section 277 on present sections 651 and 661 would appear to be desirable. The computations are even more confusing in the case of a complex trust or an estate.

Bill p. 173, § 302(a) [IRC new § 277(c)(1)(A)(i)]
Allocable Expenses—Interest

It seems improper to disallow deduction of interest payments under section 265 of the Code because they are related to tax-exempt interest received and at the same time to allocate some of the taxpayer's *other* interest payments in part to the same tax-exempt interest. If section 277 is enacted, section 265 should be repealed or the numerator of the "Section 277 Fraction" (section 277(b)) should exclude the tax-exempt interest which results in a section 265 adjustment at least to the extent of the section 265 disallowance. Furthermore, interest that is specifically attributable to carrying income-producing property should be excluded from the numerator of the "Section 277 Fraction" just as interest paid or incurred in the conduct of a trade or business is excluded under proposed section 277(c)(1)(B).

Bill p. 174, § 302(a) [IRC new § 277(c)(1)(A)(ii) and § 277(c)(1)(B)]
Allocable Expenses—Taxes

These provisions define allocable expenses to include taxes except taxes paid or incurred in the conduct of a trade or business. We believe it is improper to allocate any taxes which are incurred on taxable income, such as compensation or taxable investment income, or which are imposed on income-producing property, between taxable and tax-exempt income. These are deductions which in fact are economically attributable entirely to taxable income and are a cost of realizing the taxable form of income, as is already recognized in the exception proposed in section 277(a)(1)(B) relating to taxes incurred in the conduct of a trade or business. It is submitted that section 277(c)(1)(B) should be expanded to except from the definition of allocable expenses taxes paid or incurred on taxable income or on income-producing property.

Bill p. 174, § 302(a) [IRC new § 277(c)(1)(A)(iv)]
Allocable Expenses—Charitable Contributions

The inclusion of charitable contributions in the list of allocable expenses presents a serious policy question. Under this provision an individual who has tax-exempt income would receive a lesser tax benefit from an identical charitable contribution than an individual who has no tax-exempt income.

The classes of organizations most seriously affected by this provision would be those charitable and educational institutions dependent primarily for their support on medium and large-sized gifts from individuals who measure their gifts by their "after-tax" cost. Thus while other types of "allocable expenses" are for the most part involuntary payments and their amount should not be appreciably affected by enactment of section 302, charitable contributions are by their very nature voluntary. The amount of charitable giving above the $1000 level depends largely on the tax effect of such giving. Recognition of the impact of this on private colleges, hospitals, etc. resulted in a narrowing of the scope of section 201(c) and (d) of the bill (taxing charitable contributions of appreciated property) to the point where it will apply to only a small percentage of such contributions. However, section 302 is not similarly restricted and partially disallows the charitable deductions in question in *all* cases where such unrealized appreciation (plus other forms of exempt income and preferences described in section 302) exceeds $10,000. The inclusion of charitable deductions in "allocable expenses" under section 302 will undoubtedly cause many individuals

who have previously made substantial charitable gifts of appreciated property to stop making such gifts.

Bill p. 175, § 302(a) [IRC new § 277(c)(2)(A)(iv)]
Allowable Tax Preferences—Charitable Contributions

The possibility of a circular computation under this section has already been noted in our discussion of pages 119-120 of the bill.

Bill pp. 175-176, § 302(a) [IRC new § 277(c)(2)(B)]
Interest on Certain Governmental Obligations

Exempt interest for purposes of section 302 of the bill is to be taken into account only with respect to obligations issued after July 12, 1969. However, as stated in the introduction to this Report, the Section of Taxation is opposed to the retroactiv application of tax legislation, and, therefore, if this provision is accepted on policy grounds, it is submitted that the change should apply only to obligations issued after the date of enactment.

Bill p. 176, § 302(a) [IRC new § 277(c)(2)(C)]
Depletion and Intangible Drilling and Development Costs

Computation of cost depletion requires an estimate of recoverable reserves. It is believed that many of the larger operators and practically all of the smaller operators claim percentage depletion. This section will require all such individual taxpayers also to compute cost depletion with the attendant engineering expenses.

It is suggested that this burden be removed by giving the taxpayer an option to compute cost depletion or amortize his costs over a 10-year period. This would achieve the objective of the bill while relieving the taxpayer of an expensive cost depletion computation.

SUBTITLE B—INCOME AVERAGING

Sec. 311. Income Averaging

Bill pp. 180-181, § 311 [IRC amended §§ 1301, 1302, 1303 and 6511]
Income Averaging

This provision appreciably extends the benefit of the income averaging provisions and simplifies their operation. Perhaps more should be done to reduce the inequities between taxpayers with level and taxpayers with fluctuating incomes. Consideration might be given to permitting aver-

aging the excess over 100 percent of average base period taxable income, provided the $3,000 test is met.

In the interest of clarity the reference "(relating to penalties applicable to certain amounts received by owner employees)," should be inserted after "section 72(m)(5)" in line 24, bill p. 180.

SUBTITLE C—RESTRICTED PROPERTY

Sec. 321. Restricted Property

Bill pp. 185-188, § 321(a) [IRC new § 85]
Restricted Property

Under this provision a person receiving restricted property for services becomes taxable when his beneficial interest is transferable even though still subject to forfeiture. Furthermore, he is taxed at full market value determined without giving effect to the forfeiture provision or any other provision which will lapse. Thus a person could be taxed at full value on property which he has not yet earned and may have to forfeit, even though he could dispose of it only at a substantial discount. It is suggested that an employee be made taxable prior to termination of forfeitability only if he transfers the property to an unrelated third party and then only to the extent of the consideration received. This inequity in the proposed provision can be avoided by drawing the contract so as to restrict transferability until the rights become nonforfeitable. Hence the provision serves only as a trap for the unwary.

The key reference in the proposed new section is to the "transfer" of stock. Presumably "transfer" is intended to refer to the point at which a taxpayer obtains equitable title to shares, not when legal title passes (i.e., issuance of the certificates). This is the current rule for determining the holding period for purposes of calculating long-term gain. The legislative intent would be more clearly expressed by substituting "acquired by" for "transferred to" in line 11, bill p. 185, and the word "acquired" for "transferred" in lines 6 and 7, bill p. 188.

Even with these changes the proposed amendment raises serious problems for a closely held corporation. Such a corporation must often offer one or more key employees a greater equity interest than can be made available through a qualified stock option plan, but because of the practical problems involved in the disposition of stock by minority stockholders can do so only with substantial restrictions on transferability of the stock. The bill will expose such employees to the receipt of substantial amounts of ordinary income in one year.

The application of the proposed rules would appear to be unfair where the restrictions have a business purpose and the parties have in good faith fixed the fair market value at which the stock was sold to the employee. It is suggested that a provision be included similar to that appearing in section 422(c)(1).

Bill p. 188, § 321(a) [IRC new § 85(f)]
Transition Rules

There is a conflict between the effective date in section 321(d), "the date of enactment of this Act," and the June 30, 1969 date in the transition rules of proposed section 85(f). We submit that sound legislative policy would not make the new provisions applicable to transfers prior to the date of enactment.

Section 85(f)(3) establishes an effective date applicable to property transferred after February 1, 1970, if pursuant to a plan adopted and approved before July 1, 1969. This is apparently to enable taxpayers to make a distribution of restricted stock for the calendar year 1969 under the old rules. This intention could easily be frustrated because of administrative or clerical inability to make the transfers within one month after the close of calendar year 1969. It is suggested, therefore, that this date be extended to April 1, 1970.

Further, section 85(f) operates in an unfairly retroactive manner. Prior to the proposal of the bill, the Internal Revenue Service had announced its intention to change the tax treatment of restricted stock. Amended regulations were to go into effect in November, 1968. The Service changed the effective date of the regulations to July 1, 1969, thereby permitting taxpayers who were "granted" options for restricted stock on or before June 30, 1969, to treat their income in the manner provided by the old rules. The new legislation has turned back the clock and has made April 22, 1969, the cutoff date, unless an option is both "granted" before July 1, 1969 and exercised before February 1, 1970.

Furthermore, relying on provisions of the existing regulations for statutory stock options taxpayers have assumed that they could, by analogy to the provisions of section 425(i) or Treasury regulations § 1.421-7(c), treat options as "granted" when action was completed by the Board of Directors and were not required to wait until shareholder approval to treat the options as "granted."

The House report, part 1, p. 89, indicates that, if shareholder approval is required by state law to make the options effective, such shareholder approval must *also* have occurred before July 1, 1969, in order for the

option to be treated as "granted" before that date. Such a requirement will unduly penalize taxpayers who obtained options before July 1, 1969, subject to shareholder approval, relying upon the Service assurance of the continuation of the old treatment without realizing that they would need immediate shareholder approval.

Bill pp. 188-190, § 321(b) [IRC amended §§ 402(b) and 403(c)]

Non-exempt Trusts and Nonqualified Annuities

Under present rules relating to nonexempt trusts, the amounts payable to an employee are treated as ordinary income. This is so whether they are taxed to him at the time of contribution to the trust (if then non-forfeitable) or when distributed to him. Accordingly, there is no reason to change the rules of nonexempt trusts to preclude the possibility of converting ordinary income into capital gain. Thus the basic purpose of the restricted stock proposals is not applicable to nonexempt trusts.

Treating interests in nonexempt trusts in the same manner as restricted stock would tend to put smaller and less financially sound employers at a disadvantage. Many employers award annual bonuses which require an "earn-out" period of several additional years. Where the employer is a financially sound company and can utilize a plain contractual obligation, the employee will not receive taxable income until distributions are made. But, in the case of an employer whose financial status is not as sound and who must make contributions to a nonqualified trust in order to give his employees comparable protection, the employee would be forced, under proposed section 402(b), to pay a tax when the earn-out period ends. Thus, in the latter case, the employee is at a substantial disadvantage, unless he has other available and noncommitted funds to pay a tax prior to actual distribution from the nonexempt trust. This economic disparity would tend to help large companies obtain and retain quality management, to the corresponding disadvantage of the smaller or less financially secure companies.

The "economic benefit" theory of taxation should be sparingly used, since it demands the exaction of a tax from an employee before he has received the dollars with which to pay it. It seems proper to apply the economic benefit theory to the area of restricted stock since the employee is already the registered owner, can vote the stock, and can receive dividends on the stock. This is not the case with respect to funds held in a nonexempt trust. Why, then, apply the harsh effects of the economic benefit theory in this situation?

The corresponding question of the deduction to the employer in these situations should also be dealt with in the statute. This would require

an amendment to section 404(a)(5) of the Code. The rule of *Russell Manufacturing Company v. United States,* 146 Ct. Cl. 833, 175 F.Supp. 159 (1959), should be adopted by statute, permitting the employer a deduction when the employee becomes taxable, even though the employee's rights were forfeitable when the contribution to the nonexempt trust was made. It would seem, however, that the employer's deduction should be limited to the amount which the employer contributed to the trust.

SUBTITLE D—OTHER DEFERRED COMPENSATION

Sec. 331. Deferred Compensation

Bill pp. 190-193, § 331(a) [IRC new § 1354]
Deferred Compensation

1. This section, which would penalize deferred compensation by taxing it, not at the rates for the year it is received, but at the *higher* of the rates applicable to the taxpayer in the year earned or the year received, introduces complexity into the law which is out of proportion to any "tax preference" involved.

The provision contains technical deficiencies. Read literally, the words "deferred compensation payment" could be deemed to cover any payment which is "properly attributable" to services rendered in a period prior to that in which payment is received. It could thus apply to a bonus or current profit-sharing payment, measured by profits of the year the services were rendered, but paid only after the financial results have been determined. It might also cover a retroactive pay increase. Since non-employees are embraced in the provision, it could cover the unbilled or uncollected fees of a doctor, lawyer, engineer or architect, whether or not the amount was determinable or collectible in the year the services were rendered.

In such cases, it would ordinarily be fortuitous that the income fell in a different bracket than was applicable in the year the services were rendered. To apply the section to such cases would, for those who find themselves regularly in the situations mentioned, require complex calculations and adjustments every year of their active careers, and would result in always imposing the greater, never the lesser, of the taxes applicable in the two years involved each time.

There are what may be deemed borderline cases involving an element of tax planning. A professional man, anticipating a lower income year or a tax cut, may refrain from billing until after the end of a year. But that is not the classic "deferred compensation" arrangement to which

the provision seems to be addressed—one that obtains for the employee or independent contractor some of the benefits of a qualified retirement plan without having to meet the requirements of section 401. House report, part 1, p. 90.

It is suggested that the bill adopt the language found in section 404(a) ("a plan deferring the receipt of such compensation") to make it clear that the foregoing cases are not embraced in the provision. Under section 404(a)(5) and its predecessor (section 23(p) of the 1939 Code), it was established that bonuses paid after the end of the year, when profits were ascertainable, were "current payments for current services rendered" and were, therefore, not "deferred compensation." Rev. Rul. 55-446, 1955-2 C.B. 531, 532; Rev. Rul. 57-88, 1957-1 C.B. 88, 89.

2. The first formula for computing the minimum tax requires substantial recordkeeping which may be an undue burden to place on a taxpayer, who may remain an employee for a considerable period of time prior to receiving deferred compensation payments.

To avoid the recordkeeping problems of the first formula, the employee is forced to use the second formula which is arbitrary and does not make allowance for non-compensatory income, such as that derived from the sale of a capital asset, in selecting the three highest years. Thus, using "taxable income" as a base for computation purposes could result in a substantially distorted application of tax bearing no relation to an employee's earned compensation.

In addition, the two formulas fail to cover the situation of the transitory employee who may not remain at a job for more than a couple of years, but yet leaves one or more of the jobs with a deferred compensation arrangement payable at age 65. The second formula will not operate in this case and if he has not kept records to apply the first formula, he will be unable to compute the "minimum" tax under section 1354. There is a further problem if the employee works for an employer for one year, receives a deferred compensation arrangement payable at age 65, terminates his employment and then, years later, again works for the same employer. Would the measuring period under the second formula include years in between with other employers?

3. The problem of income in respect of a decedent as related to deferred compensation is unresolved, as is the problem of deferred compensation paid to a widow and that of the joint tax return vs. the individual tax return.

No consideration is given to the situation where a bookkeeping investment account is used in conjunction with deferred compensation and the employee grosses a much larger payout than that originally deferred for him. The account may continue to grow when the employee is no longer

employed by the employer but payout is deferred. Treatment of the excess is unclear.

Finally, section 1354(b) would seem improperly to leave to regulations the problem of determining the years of an employee's service to which his deferred compensation is attributable.

SUBTITLE E—ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

Sec. 341. Treatment of Excess Distributions by Trusts

Bill p. 194, § 341 [IRC amended §§ 665-668]
Accumulation Distribution from Trusts

The evil which the section seeks to remedy is the tax avoidance that results from multiple trusts created by the same grantor for substantially the same beneficiaries. Undoubtedly, other accumulation trusts have been used for tax avoidance purposes, but most of them are used for legitimate purposes, such as accumulation to avoid the necessity of court appointed guardians or conservators. In any event the revenue involved in the single accumulation trusts used for tax avoidance purposes would appear to be insignificant.

There are a number of other suggested solutions to the evil of multiple accumulation trusts that are much less complex than the proposal in the bill. These solutions do not impose unwarranted complexity on single trusts which have accumulated income over a long period of years and which involve little revenue.

The enactment of section 341 will greatly increase the complexity of taxing provisions already excessively complex. The present rule involves a five-year throwback. The complications involved in applying a statute which reaches back over a longer period of years would be much greater. The application of the throwback rule involves recomputing the tax of the beneficiary for each of the preceding years in which trust income was accumulated, taking into consideration various classes of income as well as deductions and credits and amounts which have been distributed in prior years. The proposed provisions for limited tax preferences and for allocation of deductions will not simplify these recalculations. A glance at the present Schedule J to be filed with the fiduciary income tax return on form 1041, calling for information in reference to "allocation of accumulation distributions," and the instructions on the back of the form, is sufficient to show that the present rules are exceedingly complex.

Most trusts providing for accumulation are not created because of tax considerations and have sound social purposes. The most frequent accumulation provision relates to income received during the minority

of a beneficiary or during the existence of some other disability of the beneficiary. In many instances the operation of this provision will result in refunds. Certainly where a minor beneficiary has no substantial amount of other income, the trust will pay a higher tax because it has only a $100 exemption whereas the beneficiary has a $600 exemption plus at least the standard deduction. It is doubtful that the difference in tax would justify the burdensome task of attempting to recompute the tax over a long period of years.

It would be necessary for trustees, as well as individuals who are potential beneficiaries of accumulated income, to preserve their income tax returns and other records for the duration of a trust which accumulates income. In order to examine such returns properly, the Internal Revenue Service should preserve the returns of trusts and individuals for an indefinite period. If an unlimited throwback rule is enacted, it will probably be necessary for the Internal Revenue Service to train a large number of revenue agents to examine returns involving accumulation distributions. In view of the comparatively small amount of revenue involved, it is likely that the time of such agents could be spent more profitably in other fields.

1. The administration of a statute which requires the examination of income tax returns and records extending back over a large number of years would be a constant source of irritation and expense to taxpayers and the Internal Revenue Service alike. The "short cut method" provides for computing the beneficiary's tax by including the average annual amount of accumulated income in his return for the current and two preceding years. However, in order to do that, it would be necessary to know the exact amount of accumulated trust income in each of the preceding years, the amount of each class of income, the amount of each partial distribution, and the amount of tax paid by the trust. In order to determine whether the "short cut method" or the "exact method" would produce a lower tax, it would be necessary to make both sets of computations.

2. The application of the unlimited throwback is not clear where there is a "pour-over" trust, i.e., on termination of one trust, the assets are transferred to a second trust (either newly created or already in existence). Logically, the accumulation and tax payments of the first trust should carry over to the second without imposition of a second tax until distribution is made to an individual. Similarly, where on the death of an income beneficiary a trust is split into two or more separate trusts for successor income beneficiaries, provision should be made for splitting the accumulations. Presumably this problem can be readily avoided by drafting the old trust in such a way as to keep it in existence. However,

many existing trusts were drafted by reference to existing rules and provide for "pour-overs" on termination, as, for example, the distribution of assets in the marital trust to the residuary trust following the death of the widow.

3. The retention of old trusts may be undesirable from the standpoint of trust administration. For example, assume separate trusts for the benefit of each of three children with provision that if one should die without descendants, the corpus is to be divided between the other two trusts. Such an arrangement may be superior to a provision that the first trust continues for the benefit of the other two children in equal shares.

The complexity of the provisions introduced by the bill may lead to distortion of normal trust management. For example, the operation of the "shortcut" method makes it desirable for the trustee to accumulate at least some small amount of income each year of the trust so as to reduce the average annual income.

Conversely, the effect of the bill may be to cause trustees to distribute income currently to minors (or other beneficiaries), if they have discretion to do so. Such action is frequently unwise from a property management standpoint and will in many cases (especially with minors) reduce, rather than increase, the tax collected on the income.

Bill p. 194, § 341(a)(1) [IRC amended § 665(b)]
Elimination of Minority, Emergency, and De Minimis Exceptions

The retention of a de minimis provision (which could well be increased from $2,000) would greatly alleviate administrative problems. In order to avoid the multiple trust problem, the de minimis provision could be allowed only for years in which distributions are made from one trust to the same beneficiary.

Trusts to accumulate income during minority are usually not used to avoid taxes, but for legitimate, non-tax reasons. For example, it is common to accumulate income during the minority of a beneficiary, since he is not capable of, or legally qualified to, manage his property. Since the minor usually has little or no other income, no tax avoidance results. The existing statute recognizes this fact and excludes from the throwback any income accumulated before the beneficiary attains the age of 21.

There are other situations as well where a beneficiary is under a legal disability or is not capable of managing property, so that the trustee is required to manage the property and distribute income as and when needed. Since these needs may vary from year to year, and bear no direct relation to the amount of trust income, there may well be accumulations in some years, followed by distributions of more than current income in other years. The present law recognizes certain situations of this type by

exempting distributions for "emergency needs" of a beneficiary from the throwback.

Bill p. 195, § 341(a) [IRC amended § 665(e)]
Effective Dates and Transitional Rules

The effective date of section 341 should be changed. To be fair to taxpayers who have created trusts in reliance on the present statute, the new provisions should apply only to trusts created after the date of enactment. Many existing trusts would have been drawn differently if the new rules had then applied. For example, many trusts now require accumulations during minority, whereas with the new law it may be desirable to give the trustee discretion to accumulate or distribute income.

If the new rules are not limited to new trusts, the section should apply only to income accumulated after the date of enactment. The new rules are now made applicable to income accumulated during the last five years (*i.e.*, years ending after April 23, 1964), apparently on the basis that distributions of income from those years may be subject to the throwback of the present law. This fact, however, does not justify making the new rules retroactive. Beneficiaries, as well as trustees in some instances, may not have retained all of the records which they must have in order to use the exact method for these years. As a general rule records are required to be kept for tax purposes only for three years after the tax return is filed. There was, therefore, no reason to retain them longer in situations where the present throwback rule is not applicable. The most obvious examples are minors who have not had to file tax returns. Under the bill, such beneficiaries who have not had any occasion to keep records could not use the exact method and they would have available only the shortcut method which can cause great distortions, depending on the amount of income from unrelated sources. It should also be pointed out that many trusts have been established either through inter vivos instruments or through testamentary provisions which cannot be changed. These might have contained different provisions if the rules of the proposed bill had been known when the instruments were originally prepared. This is especially true in the case of trusts for the benefit of minors.

Bill pp. 198-199, § 341(d) [IRC new § 668(b)]
Alternative Methods of Computing Tax on Amounts Deemed Distributed in Preceding Years

The shortcut method has a built-in inequity in that in the year of termination of a trust the beneficiary will normally have at least one year's income from the property of the trust includable in his current

income so that the income representing average prior accumulations is placed in a higher bracket for that year. An option should be granted in computing under the shortcut method to disregard the year of termination of a trust and spread over the three prior years.

There would appear to be no justification for prohibiting a beneficiary who was not alive for each year of the accumulation from using the exact method with respect to those years following his birth where he can establish the necessary facts. In such a situation the beneficiary should be allowed to use the shortcut method with respect to the balance of the distribution. Such splitting would appear to be possible if the trustee can make a distribution in two taxable years with the first being in such amount that no portion would be allocated to a year before the beneficiary's birth. This further complicates trust administration. Such proposed prohibition discriminates against after-born beneficiaries of trusts.

Bill p. 200, § 341(d) [IRC new § 668(b)(4)]
Multiple Distributions in the Same Taxable Year

The bill provides that where accumulation distributions are made from more than one trust to a beneficiary in the same taxable year, the beneficiary may determine which distribution is made first. The reason for this provision is puzzling as the order of distribution would not appear to affect the computation of tax.

Sec. 342. Trust Income for Benefit of a Spouse

Bill p. 203, § 342(a)(1) [IRC amended § 677(a)(1) and (2)]
Income for Benefit of Grantor's Spouse

The provision of the bill which will tax the grantor on income actually distributed to the spouse may be open to question. Where a joint return is filed, no problem is presented. However, in case of divorce, inequities may result in the year of divorce and problems in negotiating property settlements may be created. Such problems could be eliminated by providing for taxation of the spouse in all cases where the income is actually distributed to her in the current year. Such a provision would not appear to present any serious tax avoidance problem.

Bill p. 203, § 342(a)(1) [IRC amended § 677(b)(3)]
Payment of Insurance Premiums

There would also appear to be equitable grounds for providing that income which may be used to pay premiums on insurance on the spouse's life should not be taxed to the grantor unless the income is actually so

used. There appears to be no greater tax avoidance possibility here than in the case of income usable for support obligations. In most instances such insurance will be payable for the benefit of children and not the grantor or his spouse. Such possibilities may well creep into trusts for the benefit of children where the children own policies of insurance on the life of the spouse. The proposed rule creates one more pitfall to be watched in situations where no tax avoidance is involved. In addition, the suggested change in the proposed bill would make it easier to administer since the existence of insurance policies on the life of the spouse may be unknown to the trustee. The possibility of use of trust income to pay such premiums may well be doubtful, raising complex legal issues. Of course, where income of the trust is actually used to pay premiums, that fact is known to the trustee and is easy to examine. In fact, it might be desirable to extend the same rule to insurance on the grantor's life.

Bill p. 203, § 342(b)
Effective Date

The amendments should be made applicable only to trusts created after the enactment of the amendment. Last minute tax avoidance is considered less important than the principle that a taxpayer may rely upon an existing statute in planning his affairs.

TITLE IV—ADJUSTMENTS PRIMARILY AFFECTING CORPORATIONS

SUBTITLE A—MULTIPLE CORPORATIONS

Sec. 401. Multiple Corporations

Bill pp. 204-206, § 401 [IRC new § 1561]
Multiple Corporations

The provision in section 1561(a), with respect to the apportionment of the limitation on the life insurance company small business deduction, confers power upon the Secretary rather than the taxpayer to determine whether there shall be any but an equal division of the aggregate limitation among the component members of the group. This is at variance with the treatment in the same subsection of the surtax exemption allowed to a controlled group.

The cross-reference to be added to section 804 should be to section 1561 as well as to section 1564.

The bill would have no effect upon mutual companies other than life

subject to tax under section 821. Since such a company has no stockholders, it can be a member of a controlled group of corporations within the meaning of section 1563(a) only as the common parent of such group. In other words, only one mutual company can ever be a member of a controlled group as long as the existence of such a group is determined by reference to stock ownership. For this reason, the proposed amendments in bill section 401(g) to sections 821, 832(c) and 501 (c)(15) designed to apportion or limit the dollar amounts otherwise provided in those sections among all the corporations taxable under section 821 that are members of a controlled group are of doubtful effectiveness.

No part of the limitations on surtax exemptions, the $100,000 amount under section 535(c)(2), the investment credit or first year depreciation provided for in bill section 401(a) through (f) would apply to any company taxable under section 821. All such provisions are made only in respect of the component members of controlled groups. A section 821 company is an excluded member by reason of section 1563(b) (2)(D).

SUBTITLE B—DEBT-FINANCED CORPORATE ACQUISITIONS AND RELATED PROBLEMS

Sec. 411. Interest on Indebtedness Incurred by Corporations to Acquire Stock or Assets of Another Corporation

Bill pp. 219-227, § 411 [IRC new § 279]

Interest on Indebtedness Incurred by Corporations to Acquire Stock or Assets of Another Corporation

This provision is intended to discourage acquisitions by large corporations through the use of debt instruments having characteristics making them akin to equity. Although section 279 might produce a proper tax result in the relatively few situations to which it would apply, it is believed that it would represent an unwise addition to the tax law. The section's limited coverage, the likelihood that it would contribute little toward accomplishment of its major purpose, its lack of coordination with other provisions of the Code, the possible implications which might arise from the provision with respect to situations not covered, and its bewildering complexity, appear to outweigh the limited benefits likely to result from it in correcting a few cases of abuse.

1. A major stated purpose is to discourage concentration of economic power through corporate acquisitions which may fall outside the scope of the antitrust laws because of their conglomerate nature. In relation to this purpose, the provision seems questionable.

Even if it is conceded that it may sometimes be proper to use tax measures to attain objectives other than raising revenue, the goal might be better achieved by legislation in the antitrust field where the solution can be more complete and more precisely tailored to the nature and scope of the problem.

The provision is too narrow in scope materially to advance this objective. It would not apply to nontaxable acquisitions. Moreover, even the use of debentures in taxable acquisitions will probably not be significantly curtailed. Whereas its antecedent, H.R. 7489, the so-called "Mills Bill," disallowed interest on all debentures providing major consideration for acquisitions, section 279 confines the disallowance to debentures meeting certain conjunctive statutory tests for resemblance to equity. Although this limitation is appropriate as a matter of tax theory and equity, it limits the likely effectiveness of the provision in that:

(a) Its application only to indebtedness subordinated to claims of trade creditors will permit ready avoidance by issuance of indebtedness not so subordinated. In the case of conglomerates and other holding companies operating through subsidiaries, claims of trade creditors are frequently insignificant;

(b) Its application only to convertible debt or debt associated with an option will permit avoidance by issuance of ordinary debentures; and

(c) Its application only where the issuing corporation fails either the 2-to-1 debt-to-equity ratio or the 3-to-1 income-to-interest test will probably make it ineffective with respect to many large corporations; and others may be able to conduct their affairs so as to render it ineffective by intermixing acquisitions in which no debt is issued.

The need for such a provision to discourage debenture acquisitions will be largely eliminated by the enactment of section 412 of the bill, in which receipt of marketable debt securities will ordinarily disqualify the seller's gain for installment treatment. Deferment of the seller's gain until collection or disposition of a debenture received in a sale of stock or assets has been a key element in the popularity of debenture acquisitions. Imposition of tax on the seller's receipt of the debentures should inhibit future recourse to this form of acquisition.

2. Section 411 cannot be justified as an attempt to re-define the distinction between debt and equity for tax purposes because of its failure to deal comprehensively with this subject. Its application is restricted not only by the $5,000,000 allowance but also by its confinement to "corporate acquisition indebtedness"; there is no apparent tax policy justification for distinguishing between such indebtedness and debt issued

for other purposes. Moreover, the debt-equity distinction is applied only to the deductibility of interest. There is no attempt to deal with the other situations in which the distinction is relevant, such as the relative consequences of a retirement of debt or equity or receipt of securities or stock in a merger, eligibility of payments for the inter-corporate dividend deduction, the individual dividend exclusion, and the like.

In spite of its limited coverage, the provision may have unfortunate and unpredictable collateral effects on the state of the tax law as to the distinction between debt and equity. The principles applied in distinguishing debt and equity for these purposes have been developed and refined over the years in a long series of court decisions. Some of these principles are at variance with the standards established in section 279. While the section itself, as well as the House report, part 1, p. 107, states that no inference is to be drawn from the provision as to the nature of any instrument for the purpose of any other provision of tax law, the possibility that those charged with administration of the tax laws, as well as the courts, may be influenced by these standards cannot be ignored. It is submitted that the tests of section 279 would not afford a suitable statutory definition of indebtedness for all purposes.

3. The definition of corporate acquisition indebtedness in section 279 (b)(1) to mean an obligation "issued to provide consideration for" an acquisition is apparently intended to include securities issued to obtain cash to finance cash acquisitions. The purpose of the borrowing appears to control and the determination of this purpose will give rise to numerous problems of application in situations where cash acquisitions are made by corporations concurrently engaged in borrowing for various purposes:

a. Corporate borrowings are frequently made to raise cash for a number of purposes. The bill leaves it unclear whether the obligation will be acquisition indebtedness only if issued solely to provide consideration for a purchase; whether the principal purpose will determine the status of the entire issue; whether the entire issue will be tainted if any portion is to provide such consideration; or whether the issue will be fragmented and only the portion issued to provide consideration will be acquisition indebtedness.

b. The exact uses of borrowed funds and the amounts to be required for each use are frequently not known at the time the obligation is issued. In such a case, it is difficult to see how the necessary determination could be made, unless there is authority to make it retrospectively by reference to the actual use of funds.

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c. Funds may be borrowed for one purpose and used for another. Thus, due to a change of plans, funds borrowed for plant expansion or working capital may be used for an acquisition or vice versa. Is the original purpose or the ultimate use controlling?

d. Obligations whose proceeds are used for other corporate purposes may free internally generated cash for acquisitions. Should these be deemed to have provided such consideration and, if so, will the statute permit it?

4. The provisions of section 279(b)(1) apparently would apply regardless of how few shares are acquired. Recognizing that ownership of a relatively small percentage of stock may represent effective control, it may nevertheless be desirable to exempt purchases for investment by adding a minimum percentage ownership test, say 5 or 10 percent.

In section 279(b)(1) (Bill p. 220, line 12) the word "except" should be changed to "provided."

The House report states that, in applying the debt ratio and interest coverage tests to a financial institution, its obligations are to be reduced by amounts owed to it and its interest expense is to be reduced by its interest income. (House report, part 1, p. 106). The bill in section 279(b)(4), (c)(2) and (c)(3), makes no such exception. If one is to be made, it should be set out in the statute.

The use of the adjusted basis of assets in determining the debt-equity ratio as provided in section 279(c)(2) is unsound in theory and would be inequitable in practice. This standard has been uniformly rejected in the cases. Rapid depreciation on the one hand and inflation on the other have made adjusted basis a poor measure of the capacity of tangible assets to support debt; and intangible values would ordinarily be left totally out of account. The desire for ease of administration is understandable but does not justify use of this standard.

In the case of acquisition of less than "control" of a corporation as defined in section 368(c), the acquired corporation's earnings under section 279(c)(3)(A) are not considered in testing interest coverage. The control definition of section 368(c) is unduly restrictive, since the required ownership of 80 percent of each class of non-voting preferred stock is hardly relevant to the acquiring corporation's access to the acquired corporation's earnings. Substitution of a control test which excludes non-voting preferred stock would be preferable and would be consistent with section 279(g). Moreover, for accounting purposes, corporations customarily consolidate earnings of 50 percent-owned subsidiaries; and development of an allocation formula to permit inclusion of a proper share of earnings and interest in such cases

might prevent some unfair results. Since future interest is to be measured against past earnings, the latter should be as inclusive as possible.

In order to prevent distortion and manipulation, it would be desirable in section 279(d)(3)(B) to exclude extraordinary gains and losses from the earnings used in the interest coverage test.

In excluding acquisitions of certain foreign corporations, the requirement in section 279(f) as to income from foreign sources should be stated in terms of a specified percentage, e.g., 80 percent, rather than by means of the imprecise "substantially all" test.

Sec. 412. Installment Method

Bill pp. 227-229, § 412 (a) and (b) [IRC amended § 453(b) (1) and new § 453(b)(3)]

Installment Method: Periodic Payments Requirement

If these provisions are adopted, the effective date should be changed to exclude sales made prior to the date of enactment of the bill or pursuant to contracts made prior thereto.

The stated purpose of the amendments is "to limit the availability of the installment method of reporting gain to situations where" payments "are spread relatively evenly over the installment period." (House report, part 1, p. 108). Presumably the Secretary's regulations would implement this purpose. Such a drastic restriction of the installment method appears highly undesirable. The installment method was made available, in cases where receipt of a major part of the consideration for a sale is deferred, to permit postponement of tax until receipt of the consideration. Otherwise, the taxpayer might lack funds to pay the tax; or he might pay a tax based on expected payments which are never received. The need for this deferment is at least as great where the deferred payments are irregular or uncertain in time or amount as where they are regular and definite; and where the installments are few in number as where they are numerous. Irregularity of payments results far more often from business considerations than from a desire to reduce or defer tax. Denying use of the installment method in such cases would work considerable hardship on taxpayers required to pay a tax that might largely absorb or even exceed the down payment received.

1. It is doubted that there is any significant abuse of the installment method which the amendments would correct. The House report cites the uncertainty in present law as to the number of installment payments required to qualify for the installment method. (House report,

part 1, p. 108). This uncertainty could be removed by requiring at least two payments. The only other reason given in the House report is that it is not "appropriate" to allow use of the installment method where the number of payments is limited, especially in the case of a single installment deferred for a long period of time (House report, part 1, p. 108). Why this is not "appropriate" is not stated.

Adoption of proposed section 453(b)(4), disqualifying readily marketable corporate securities as installment obligations, would eliminate the only substantial problem which is believed to exist under present law.

2. If the provision is adopted, its effective date should be changed. At present it applies "to sales or other dispositions occurring after May 27, 1969." (Section 412(c)). Sales made pursuant to contracts entered into prior to the effective date should be excluded in order to prevent inequity and hardship.

3. It is not clear whether the percentage payment requirements of proposed section 453(b)(3)(B) apply to the total selling price or to the principal amount of the installment obligation resulting from the transaction. The House report refers to "the principal of the loan"; but the provision itself refers simply to "the principal" which may be intended to mean the principal amount involved in the transaction. (House report, part 1, p. 108). For example, if 20 percent of the purchase price is paid at the time of sale, 10 percent later in the year of sale and the remaining 70 percent in subsequent installments within 4 years of the sale, it is not clear what portion, if any, of the 70 percent must be paid by the first and second anniversary dates. The apparent purpose of the provision is to require regular payments on the total price, which would lead to giving credit for any down payment by making the entire selling price the base for the percentages.

Bill pp. 227-229, § 412(b) [IRC new § 453(b)(4)]
Installment Method: Marketable Securities

The phrase "readily tradable on an established securities market" in section 453(b)(4) will likely leave most taxpayers in considerable uncertainty as to what constitutes "an established securities market" and what conditions must exist before a security can be considered "readily tradable" on it. The House report sheds no light on the question. In view of the time which will doubtless elapse before regulations are promulgated, an explanation of what is meant by the phrase would be helpful.

Bill pp. 229-237, § 413 [IRC amended § 1232(a) and (b) and § 6049(a) and (c)]

Bonds and Other Evidences of Indebtedness

Throughout section 1232(a), the holding period referred to is 6 months, which is inconsistent with other provisions of the bill requiring a 12-months holding period.

Proposed section 1232(a)(3)(B) also raises several technical questions: (i) Is this provision intended to apply to any subsequent holder (as its text would seem to indicate), or only to a "purchaser" (as (C) would indicate)? (ii) It would appear that section 1232(a) would follow the bond into the hands of an heir, which was probably unintended; and that estate tax value, no matter how high, would not reduce his reportable income, which seems even more improbable. The fact that the heir's acquisition is not a purchase would preclude only the relief provided by this provision. (iii) On page 233, line 17, query whether "cost" should not read "adjusted basis." This affects the immediately preceding question, but would have other effects as well wherever there are post-acquisition items affecting basis.

Section 1232(a)(3)(C) should also relate to section 1232(a)(3)(D) to provide a consistent definition of a purchase.

Section 6049(a)(1), relating to the reporting of interest, will presumably produce information based upon original issue discount, and cannot reasonably reflect the application of proposed section 1232(a)(3)(B) which provides an adjustment for a subsequent holder related to any gain realized by the seller. In the case of most purchasers, this will invariably produce a discrepancy between the amount reported by the issuing corporation and the holder, and will presumably cause the Service's computers to show "tilt" even when the issuer and holder of a purchased obligation have reported with complete propriety. Discrepancies will presumably also be picked up by the computers where the holder is a fiscal year taxpayer.

Requiring inclusion in taxable income prior to receipt, beyond presenting the bondholder with a liquidity problem, seems substantially inconsistent with the realization concept and with the cash method of accounting. Special treatment of this one item does not seem justifiable.

The revenue considerations involved would not seem to justify the hardships that these proposals would create for bondholders and issuers or the considerable additional complexity introduced into the Code.

Sec. 414. Limitation on Deduction of Bond Premium on Repurchase

Bill pp. 237-239, § 414 [IRC new § 249]
Limitation on Deduction of Bond Premium on Repurchase

The word "repurchase" at page 238, line 8, would seem to render the provisions inapplicable to a purchase by a successor in interest to the issuer or a parent or subsidiary of the issuer.

In instances where the obligation bears an interest rate less than the going rate and is trading at its converted value, allowance as an offset of the "normal call premium" provided for at page 238, line 13, may be unwarranted.

Subtitle C—Stock Dividends

Sec. 421. Stock Dividends

Bill pp. 239-243, § 421 [IRC amended § 305]
Distributions of Stock and Stock Rights

Many problems in section 421 are dealt with only by creating a broad authority to tax and leaving it to the Secretary or his delegate to develop specific rules. This method of dealing with the problems will likely leave the law in an unfortunate state of uncertainty for years to come. Moreover, the bill would aggravate the present lack of coordination and integration of the treatment of stock dividends with other areas of subchapter C, such as the rules concerning redemptions, liquidation, recapitalizations and section 306 stock. Any regulations issued under proposed section 305 and revised regulations under section 306 are certain to be even more complex than the statute. A further effort should be made to find a simpler solution. An example of another approach is the one taken by the American Law Institute in its February, 1954, draft of Federal Income Tax Statute.

It is recommended that modification of section 305 be deferred and be made a part of and integrated with a more comprehensive technical revision of subchapter C of the Code.

1. While section 421 purports to retain the general rule of non-taxability of stock dividends, the exceptions are so broad that they reinstate the "proportionate interest" test, a test which was rejected by Congress in 1954 because of the difficulties encountered by the courts in applying it. A return to a standard of determining taxability that has already proved difficult to apply does not seem an appropriate solution, at least until other approaches have been more fully explored.

2. The Secretary would be given broad authority under sections 305 (b)(2) and 305(c) to determine whether various events have the effect

of making certain stock distributions taxable. For example, a redemption which is treated as a section 301 distribution may be determined by the Secretary to give rise also to a constructive distribution to any shareholder whose proportionate interest in the earnings and profits or the assets of the corporation is thereby increased. The House report, part 1, p. 114, gives as an example a periodic redemption plan under which each shareholder may annually elect whether to have a small percentage of his stock redeemed. But, the broad language of the statute might permit the Secretary to go much further than an across-the-board election and to determine, for example, that a 40 percent stockholder of a corporation receives a constructive distribution when a 60 percent stockholder causes the corporation to redeem 10 percent of its stock from him. Similarly, under the broad language the Secretary arguably could visit dividend taxation on the continuing shareholders in the case of a non-pro rata spin-off or of an "A" type reorganization wherein some shareholders take stock and others cash. The breadth of his authority and the lack of any standard to guide him or by which to determine the propriety of his action will produce undue uncertainty and risk of administrative over-reaching in an area of wide significance to many taxpayers. Moreover the issuance of regulations under such a complex provision of a major revenue revision is frequently long delayed. During this period, it is usually not possible to obtain rulings on proposed transactions. These considerations make it undesirable to give the Secretary such broad regulatory authority.

3. Section 305(b)(1) continues the provision of present law that a stock dividend is taxable if it is payable at the election of any shareholder in property or stock. Thus, under existing law, a common shareholder who has an election to receive a dividend in either common stock or cash is currently taxable even though he elects to receive the common stock. Where the election is to receive either common stock or preferred stock, however, under present law the shareholder is not currently taxable since "property" does not include stock in the corporation making the distribution. (Section 317(a)). The preferred stock constitutes section 306 stock and has ordinary income potential upon ultimate disposition.

It is probable that the same result is intended under the bill, since actual distributions of section 306 stock on common stock are not generally taxable. However, the status of common stock received pursuant to such an election is unclear. The rule that a shareholder who has an election to receive either stock or property is currently taxable would be retained; but section 306 stock is treated for this purpose as property which is not stock. On the other hand, under section 306(c)(1)(A), stock is section 306 stock only if it is not includible in gross

income by reason of section 305(a). Since includibility in income under section 305(a) is the point in issue, a circularity would exist, rendering it impossible to determine whether the preferred stock should be treated as property or stock.

This problem can be eliminated by amending the last sentence of section 305(a) to provide that section 306 stock shall be treated as property which is not stock only for purposes of subsection (b)(2).

In the situation described above, although the distribution would presumably not be taxable by reason of section 305(b)(1), if some of the shareholders elect to receive common stock while others elect to receive preferred stock, those electing to receive common stock would be currently taxable under section 305(b)(2) whereas those electing to receive preferred stock would not be currently taxable, but instead, assuming the problem referred to in paragraph 1 above is resolved as suggested, the preferred stock would constitute section 306 stock. It is unclear whether this is the result intended by the bill.

Under current law as well as under the bill, a stockholder who has an election to receive either cash or common stock would be currently taxable even though he elects to receive common stock. Moreover, under current law if a shareholder has an election to receive cash or preferred stock, he is currently taxable even though he elects to receive the preferred stock. Under the bill, however, it is unclear whether the shareholder would be currently taxable when he takes preferred stock because of the circularity referred to above. If the preferred stock constitutes section 306 stock, it would be treated as property which is not stock for purposes of section 305(b)(1). The shareholder would thus have an election to receive two types of property, neither of which would be treated as stock; and the section 305(b)(1) exception would be inapplicable. The test of taxability would, therefore, be under the general rule of section 305(a). Since section 306 stock is treated as property other than stock only for purposes of sections 305(b)(1) and (2), it would presumably still be stock for purposes of section 305(a) and the distribution would be nontaxable. This would appear to be an unintended result.

4. The lack of coordination which presently exists between section 305 and other provisions of subchapter C would be aggravated by the increased number of stock dividends taxable under section 305. For example, a recapitalization and a stock dividend may be substantive equivalents; but a recapitalization might be tax-free in circumstances where a stock dividend is taxable. Thus, if preferred dividend arrearages were satisfied through a distribution of preferred stock (or common stock) to the preferred shareholders, under the bill the distribution would be taxable to the preferred shareholders. However, if the

corporation recapitalized and additional preferred stock (or common stock) were issued in exchange for the dividend arrearages, the exchange would ordinarily be tax-free. (See Treas. Reg. § 1.368-2 (e)(5)). While this is also the situation under existing law with respect to distributions in lieu of cash dividends for the current and preceding year, the extension of taxable treatment to stock distributions in lieu of preferred dividend arrearages antedating the preceding year will increase the impact of the artificial distinction between such a stock dividend and a recapitalization having the same effect.

5. Under the bill, distributions of stock or stock rights made before January 1, 1991, with respect to stock outstanding on January 10, 1969 (the effective date of the existing regulations), are exempted from the amendments to section 305. Literally, therefore, where cash dividends are paid with respect to stock issued after January 10, 1969 and stock dividends are paid on stock issued prior to such date, the new rules will not apply. The House report, part 1, p. 115, indicates that this situation would be covered; but if this is intended, the bill should be amended to make it clear.

Distributions prior to 1991 are exempted where made with respect to stock issued pursuant to a contract binding on January 10, 1969. This "binding contract" exemption may not be sufficiently broad to protect all issues as to which a substantial commitment existed on January 10, 1969. Corporate acquisitions customarily involve the execution of an agreement, approval by boards of directors and, finally, shareholder approval. The parties may not be legally committed until shareholders' approval is obtained; but, as a practical matter, they are bound when the directors act. It may be appropriate, therefore, to treat transactions in which stock was to be issued by one corporation to the shareholders of another as binding on January 10, 1969, where approved by the boards of directors on or before that date.

SUBTITLE D—FOREIGN TAX CREDIT

Sec. 431. Foreign Tax Credit Reduction in Case of Foreign Losses

Bill pp. 243-246, § 431 [IRC new § 904(a)(3)]
Foreign Tax Credit

Under the bill, if recapture occurs by reason of the disposition of property, there seems to be no provision which would credit this recapture as an offset in the event that income is subsequently realized by the taxpayer in the same country. Thus, whereas section 904(a)(6)(A)

would be applicable only to the extent that the amount of any loss exceeded the amount of recapture under section 904(a)(3), there is no provision under section 904(a)(3) which would make that paragraph inapplicable if the recapture rules of section 904(a)(6) had been applied in an earlier year. This would seem to be an unintended result, which could be remedied by making section 904(a)(3) inapplicable to the extent that section 904(a)(6) had previously applied.

Where a United States taxpayer has sustained a loss in a foreign country and that foreign country does not permit a carryover of the loss to later years for purposes of computing taxes payable in that country, the effect of section 431 will be to subject some taxpayers to double taxation. In subsequent years the loss would reduce the limitation on the allowable foreign tax credit for United States income tax purposes. At the same time, since the loss does not reduce earnings for purposes of computing the foreign tax, full credit will not be available (where the foreign tax rate is high). It would seem questionable whether, in light of the general purpose of the foreign tax credit provisions to relieve the international double taxation on a unilateral basis, it is an appropriate implementation of this intent to limit the foreign tax credit in cases where the foreign loss is not taken into account in computing the foreign tax in later years.

Where the foreign country does permit a carryover of the loss for foreign tax purposes, the operation of the 50 percent rule of proposed section 904(a)(3) would operate to deprive a taxpayer of credit he is intended to have. For example, taxpayer has a loss of $100 in year 1 and profits of $100 in each of the years 2 and 3. The foreign country allows a carryover so foreign taxes are paid only in year 3. If the foreign income (numerator of the fraction) is reduced by 50 in year 2 and 50 in year 3, half the credit will be lost in year 3. Although intended as a relief provision, this 50 percent rule could thus work a hardship. This result could be obviated by giving the taxpayer an election between section 904(a)(3)(A) and section 904(a)(3)(B), or by providing that the reduction amount shall be reduced by the amount of foreign income which is offset by allowance of the loss carryover or which is subject to a tax holiday.

Consideration should also be given to confining recapture within a limited number of years from the year in which the tax benefit was realized. For example, a taxpayer who engaged in a losing activity in a foreign country during 1951-1955 and then withdrew should not be burdened with recapture if he undertakes another activity in the same country beginning in 1970.

Sec. 432. Separate Limitation on Foreign Tax Credit with Respect to Foreign Mineral Income

Bill pp. 246-251, § 432 [IRC new § 904(g)]
Separate Limitation on Foreign Tax Credit with Respect to Foreign Mineral Income

The effect of this amendment to section 904 is to deny application of any portion of the tax imposed by the foreign government on mineral income as a credit against the United States tax on other foreign income, regardless of whether any of such foreign tax on mineral income could be proved to be a royalty. The rule adopted by the bill is that the part of the foreign exaction constituting a tax may not exceed the amount of United States tax on the same income.

The provision will presumably apply to mineral income from sources within a number of countries which are not usually thought of as involving the "royalty versus tax" problem—in that such countries, while requiring the payment of royalties on property owned by the government and also imposing income taxes on mineral income, appear to set both the royalty rates and the income tax rates on the basis of considerations normally applied to such separate determinations. Such countries would include Canada, Israel and Mexico.

It should be noted, also, that overseas mineral operations often include the refining, processing and marketing of mineral products, as well as production, within the same foreign country. Not uncommonly, the foreign rates may vary in different activities and a higher tax on extraction may be acceptable because the tax on the integrated operation is acceptable. Accordingly, it might be more appropriate to consider all of the taxes imposed by a foreign country on the entire integrated operation in that country, and all of the income therefrom, as the basis for the separate tax credit limitation.

In some foreign countries, companies engaged in the production of minerals as their primary activity, and in some cases companies engaged in related activities, are required to pay a higher rate of income tax on all of their income than the rate applicable to companies engaged in other activities. It is not clear whether, under the provisions of section 432 of the bill, such a country would be deemed to impose income taxes "on such income" (that is, "foreign mineral income") at a higher rate than "on other income" (that is, other income derived by the same taxpayer who engages in mineral operations). Further, is "other income" to be income of United States nationals, or mineral income of

nationals of the foreign country, or non-mineral income of nationals of the foreign country?

The special provision permitting a United States taxpayer to elect to return to the per country limitation without consent of the Secretary or his delegate seems unduly restrictive in that the election must be made with respect to the first taxable year beginning after the date of enactment of the bill, whether or not the taxpayer in fact has foreign mineral income in that year. Authorization to make such an election without consent, could equitably be extended to the first year, after enactment of the bill, in which the taxpayer receives any "foreign mineral income."

SUBTITLE F—DEPRECIATION ALLOWED REGULATED INDUSTRIES; EARNINGS AND PROFITS ADJUSTMENT FOR DEPRECIATION

Sec. 452. Effect on earnings and profits

Bill pp. 270-271, § 452 [IRC new § 312(m)]
Effect on Earnings and Profits of Depreciation

1. The depreciation limitation under section 312(m)(1) applies to any corporation "for the purpose of computing its earnings and profits with respect to any taxable year beginning after June 30, 1972." This language presumably means that the limitation applies only in computing the earnings and profits for such year, i.e., realized in such year. However, some persons have understood it to mean that the limitation applies in determining accumulated earnings and profits whenever it becomes relevant in a taxable year beginning after June 30, 1972, and thus might require a redetermination of depreciation for all prior years in which such earnings had accumulated. The House report, part 1, p. 135; part 2, p. 103, indicates that the recomputation is to be made for all years beginning after June 30, 1972, and not for prior years, which we believe to be the intended result. This possible ambiguity should be resolved by either a change in the language of the provision or an appropriate statement in a Committee report.

2. Amendments to section 312(a)(3) and (c)(3) appear to be required in order to coordinate them with section 312(m). Under section 312(a)(3), earnings and profits are decreased by the "adjusted basis" of distributed property, which presumably means its adjusted basis as determined under sections 1011 *et seq.* However, the use of different depreciation in determining earnings and profits would give rise to a different adjusted basis for earnings and profits purposes; and it is this adjusted basis which should be used in determining the reduction of

earnings and profits under section 312(a)(3). Thus a special definition of adjusted basis appears to be required for purposes of such paragraph.

Similarly, the recognition of gain on a distribution under sections 1245(a) and 1250(a) will no longer give rise to an equivalent increase in earnings and profits. Accordingly, the amount of the adjustment of earnings and profits under section 312(c)(3) by reason of gain recognized under section 1245(a) or 1250(a) will often differ from the amount of such gain. If the existing language of section 312 (c)(3) is thought to be sufficiently general to permit this, the statute should make clear that this is intended.

The "income tax basis" rather than the "earnings and profits basis" should continue to be used for corporate distributions under section 301(b)(1)(B)(ii) and the other provisions of section 301.

3. Reference solely to "the straight line method" (Bill, p. 270, line 21) will leave problems of whether salvage value must be taken into account. A taxpayer using the declining balance method need not determine salvage value; hence the computation under section 312(m) might require determination of a purely hypothetical salvage value. It is suggested that the purposes of section 312(m) would be adequately accomplished by providing that the straight line depreciation shall be calculated without regard to salvage value.

4. The proposed amendment will, unless modified, make substantial changes in the taxation of income derived by United States taxpayers from foreign sources, although the House report gives no indication that these effects were intended or considered. A United States shareholder may, of course, receive a dividend from a foreign corporation which would now be considered tax-free under section 301 in the same manner as the distributions referred to in the House report. In addition, however, the determination of the earnings and profits of a foreign corporation has significance with respect to several sections of the Code where a change in the computation will not have the same significance which it has under section 301.

Under section 902 a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends is deemed to have paid foreign income, war profits or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or any possession of the United States on or with respect to the accumulated profits out of which such dividend is paid. Consequently, the domestic corporation is entitled to a foreign tax credit for such taxes under section 901. The term "accumulated profits" is defined by Treasury regulations, section 1.902-3

(c)(1) and (2), to mean the earnings and profits of the foreign corporation (with adjustment in certain cases). In general, the earnings and profits so referred to are to be determined under United States tax accounting standards. A taxpayer may choose to determine the earnings and profits under the rules provided by Treasury regulations, section 1.964-1 (with certain exceptions), and must so determine the earnings and profits if the foreign tax credit under section 902 is claimed for a year with respect to which the domestic corporation has elected to receive a minimum distribution under section 963.

It would appear that, if a taxpayer computes "accumulated profits" of a foreign corporation, for purposes of section 902, under United States tax accounting standards, section 452 of the bill would require the earnings and profits of the foreign corporation to be computed on the basis of straight line depreciation. If the taxpayer chose to compute the earnings and profits of the foreign corporation under Treasury regulations, section 1.964-1, subsection (c)(1)(iii) of that regulation would permit depreciation to be computed "in accordance with section 167 and the regulations thereunder." Since, in general, the regulations under section 964 do not require strict adherence in every respect to United States accounting standards, it is not predictable whether such regulations would be amended, following adoption of the proposed amendment to section 312, to require depreciation of the foreign corporation to be computed in the same manner as for a domestic corporation.

If computations of the earnings and profits of a foreign corporation required to be made under section 902 are to be affected by the proposed amendment to section 312, this will effect a dramatic change in the amount of foreign taxes allowed as a credit. In general, foreign countries allow depreciation to be taken into account for tax purposes at accelerated rates. If the foreign corporation's earnings and profits are to be determined by taking depreciation only on a straight line basis, the effect will be to increase markedly the earnings and profits of the foreign corporation and thus increase the denominator of the portion of the foreign taxes available for credit. This would decrease markedly the available foreign tax credit under section 902.

Under section 952(c), the subpart F income of a controlled foreign corporation (which under certain circumstances is taxed to United States shareholders of such corporation, even if not distributed) is limited so that, in general, the amount thereof may not exceed the earnings and profits of the foreign corporation for the year, reduced by net accumulated deficit in earnings and profits from certain prior years. While this rule may be expected to apply only to a limited number of cases, a change for post-1972 years in the computation of earnings and profits

may have effects (all of which we have not yet been able to determine) on this limitation.

Under section 960, if a domestic corporation is required to include in gross income an amount of subpart F income of a foreign corporation, it is entitled to a foreign tax credit comparable to the foreign tax credit allowed under section 902 with respect to actual dividend distributions. The same considerations discussed above, with respect to section 902 would apply in the application of proposed section 452 to the determination of this foreign tax credit.

Under section 963, a domestic corporation which elects to receive a "minimum distribution" of the earnings of a controlled foreign corporation is not required to include in gross income any amount with respect to the subpart F income of such corporation for the election year. If proposed section 452 is applied to this provision, it will substantially alter the determination of the required minimum distribution. In general, the amount of the required minimum distribution is computed by reference to the "effective foreign tax rate" paid by the foreign corporation. This in turn is determined by comparing the foreign tax paid to the earnings and profits of the foreign corporation (before foreign taxes). In addition, once the effective foreign tax rate is determined (and if such effective foreign tax rate is less than roughly 90 percent of the applicable United States corporate rate), then the amount of the required minimum distribution is stated as a percentage of the earnings and profits of the foreign corporation. If earnings and profits are to be determined for both of these purposes by taking into account only straight line depreciation, the effect will be both to reduce the effective foreign tax rate (which will increase the percentage of earnings and profits required to be distributed) and also to increase the absolute amount of the required distribution.

5. Consideration should be given to the possible effect of the application of section 452 to other determinations, including the following:

a. Under section 956, a United States shareholder in a controlled foreign corporation must include in gross income his pro rata share of the increase for any taxable year in the earnings of a controlled foreign corporation invested in United States property. Such amount is included, however, only to the extent that it would have constituted a dividend if it had been distributed. Such amount is necessarily determined by reference to the earnings and profits of the foreign corporation.

b. Under section 959, actual dividends received by a United States shareholder from a controlled foreign corporation are excluded from gross income to the extent that such distributions are made out of earnings and profits of the foreign corporation previously subjected to tax

in the hands of the United States shareholder (or, under certain circumstances, prior shareholders). Under section 959(c), "ordering rules" are established determining the extent to which distributions are deemed to be made out of previously taxed earnings and profits and out of untaxed earnings and profits.

c. Under section 1246, gain recognized upon the sale or exchange by a United States person of shares in a foreign investment company (as defined) is treated as gain from the sale of a non-capital asset "to the extent of the taxpayer's ratable share of the earnings and profits of such corporation" accumulated in taxable years after 1962. The remainder of the gain is treated under general concepts and normally will constitute a long-term capital gain.

d. A generally comparable, though more limited, provision is made under section 1248 with respect to the sale or exchange of stock in a controlled foreign corporation (as defined in section 957).

TITLE V—ADJUSTMENTS AFFECTING INDIVIDUALS AND CORPORATIONS

SUBTITLE A—NATURAL RESOURCES

Sec. 501. Natural Resources

Bill pp. 273-276, § 501(a) [IRC amended § 613(b)]
Percentage Depletion

The Section of Taxation takes no position with respect to percentage depletion rates.

The bill would limit oil and gas percentage depletion to wells located in the United States, Puerto Rico, or the Outer Continental Shelf. Depletion on foreign oil wells would be limited to cost.

1. Under existing law depletion is allowed on foreign oil only if the income is reported for United States taxation. Denial of percentage depletion on foreign oil may cause the operator to form a foreign subsidiary to operate the property, thus giving rise to the possibility of removing the income from United States taxation.

It should be pointed out that under the proposal to eliminate percentage depletion on foreign production, the holder of a royalty interest may, as a practical matter, also lose any right he would have to cost depletion because of the difficulty entailed in obtaining reserve figures on which to base his cost depletion computation. It is common knowledge that such information is carefully guarded, hence the apparent hardship to the royalty holder.

2. The disallowance of all percentage depletion on foreign oil and gas is inconsistent with the treatment proposed for other minerals. Thus percentage depletion is allowable on foreign sulphur and uranium deposits at the same rate as domestic. For metal mines, depletion on foreign deposits is allowed at 11 percent instead of the domestic rate of 15 percent. For a long list of other minerals the rate for foreign deposits is the same as for domestic.

3. The amendment defines the Outer Continental Shelf as being that defined in section 2 of the Outer Continental Shelf Lands Act. Since the enactment of the Outer Continental Shelf Lands Act, the United States has ratified the 1958 Geneva Convention on the Continental Shelf which gives jurisdiction to each country to the depth of 200 meters or such depth as can be exploited. The 200-meter depth has already been passed on the California coast. It may be that between the Convention and the Act some offshore wells might be denied depletion under the bill. This potential problem could be solved by defining the Outer Continental Shelf in line 16, page 273, as any area where the United States exercises jurisdiction.

4. On page 277, line 7, the words "economic interest" are used. This term is not defined anywhere in the Internal Revenue Code. It is suggested that it be defined, using the Supreme Court's definition in *Palmer v. Bender*, 287 U.S. 511 (1933), as follows:

> "An economic interest in a mineral property is one whereby the taxpayer by investment has acquired an interest in the mineral in place and has secured by any form of legal relationship income derived from the extraction of the mineral solely to which he must look for a return of his capital."

The term "mineral production payment" used in several places on page 277 and on page 279 also is not defined in the Code. It is suggested that the definition given by the Supreme Court in *P. G. Lake, Inc. v. Commissioner*, 356 U.S. 260 (1958), be used, as follows:

> "A mineral production payment is a right to a specified sum of money payable out of a specified percentage of the mineral, or the proceeds receivable from its sale, if, as and when produced."

Bill pp. 279-280, § 501(c) [IRC new § 615(h)]
Exploration Expenditures

Under section 615 of present law, a miner may expend up to $400,000 on exploration for minerals and elect to deduct it. Such amount may be for either domestic or foreign exploration. As to domestic exploration, under section 617 he may elect to deduct an unlim-

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ited amount but such amount shall be recouped from depletion or a sale after the mine becomes productive.

It is now proposed to make the $400,000 recoupable also. The exception, on page 280, line 12, provides that any taxpayer who has deducted less than $400,000, under either section 615 or section 617, may deduct the balance after the effective date of the amendment on foreign exploration, subject to recapture.

Thus, for the first time, foreign exploration expenditures may be deducted under section 617. Under these circumstances it would appear that taxpayers who have previously elected under section 615 should be granted a reasonable period for making a new election under section 617, if they choose to do so.

Subtitle B—Gains and Losses

Sec. 511. Repeal of Alternate Capital Gains Tax for Individuals
Sec. 512. Capital Losses of Individuals
Sec. 514. Holding Period of Capital Assets

Bill pp. 281-285, 287-290, §§ 511, 512 and 514
Repeal of Alternative Capital Gains Tax

1. Since the subject matter of these sections involves everyday activities of many taxpayers throughout the country, the proposed effective date seems particularly unfair. Undoubtedly many taxpayers, unaware of the press releases of the House Ways and Means Committee, consummated many bona fide transactions which they would not have completed had the law been changed as proposed. The result is aggravated in the case of fiscal year taxpayers by the proposed increase in the holding period required for long-term gain treatment. The effect could be to impose a tax of 77 percent instead of the anticipated 27 percent.

2. If the effective date is not changed, it is submitted that the provision should be amended to cover a number of situations that do not appear to have been considered.

Example A—A taxpayer enters into an enforceable contract in June, 1969 and the property is actually conveyed in August, 1969. Do the provisions of the pending bill include or exclude such a transaction? Is there to be a distinction between a contract of sale and a contract to sell, and if so, does this not only raise a question of the validity of the distinction but also of the practical difficulty of distinguishing between the two?

Example B—A corporation in June, 1969 agrees to liquidate under the provisions of section 337 of the Internal Revenue Code of 1954. The liquidating dividends are actually received by the stockholders in August, 1969 and in subsequent months. Do the provisions of the pending bill include or exclude such a transaction?

Example C—In August, 1969 a taxpayer sells a capital asset which has been held by him for seven months. The new averaging provisions in the pending bill apply to taxable years beginning after 1969. The existing law requires a segregation of capital assets in determining the averaging provisions. Under the pending bill can the transaction in this example be brought under the averaging provisions?

Example D—A taxpayer acquired an asset in April, 1969 which has since then materially decreased in value. Because of his individual carryover situation a short-term loss is of no benefit to him in 1969. Does the new bill permit him to defer his loss to 1970?

3. In section 511(c) the Secretary of the Treasury or his delegate is authorized to prescribe regulations with respect to taxpayers having fiscal years. However, no standards are set forth which the Secretary of the Treasury or his delegate is required to follow.

Sec. 513. Letters, Memorandums, Etc.

Bill pp. 285-287, § 513 [IRC amended § 1221(3) and § 1231 (b)(1)(C)]
Letters, Memorandums, Etc.

Although the House report, part 1, p. 149, states that "letters and memorandums addressed to an individual are considered as prepared for him," section 513 does not so provide. If this result is intended, ambiguity could be eliminated by slight modification of the statutory provision.

Sec. 515. Total Distributions from Qualified Pension, Etc., Plans

Bill pp. 290-296, § 515 [IRC new §§ 402(a)(5), 403(a)(2) (C), and 72(n)]
Total Distributions from Qualified Pension, Etc., Plans

Section 402(a)(5) uses the term "benefits accrued" in both subparagraphs (A) and (B). The closing sentence of proposed section

402(a)(5) provides for the delegation to the Secretary of regulatory authority to carry out the purposes of this change.

1. The first question is whether the word "accrued" is to include benefits which have not as yet vested. The word "accrued" is used in several different ways in describing a participant's rights in qualified plans. Accordingly, since it should be the intent of this section to include benefits which have not vested, it is suggested that the following parenthetical phrase "(whether or not vested)"—or words of similar purport—be added after the word "accrued" in the above subparagraphs.

It is not clear whether the proposed statutory language would continue the favorable capital gains treatment of existing law where an amount is paid into a trust by an accrual basis employer on, say, March 15, 1970, with respect to a plan year which ended on December 31, 1969. Presumably, the favorable treatment would include the March payment as an "accrued benefit."

2. With respect to profit sharing, stock bonus or money purchase pension plans and individual retirement income contracts, it is relatively easy to determine, at a given date, the amount of "accrued benefits." This would be the amount actually contributed to the trust by the employer prior to that date, plus the most recent plan year's contribution if the presumption of the above paragraph is correct.

In the area of pension plans, however, it is not certain whether the term "benefits accrued" refers to the actuarial value of the benefit to which the employee is entitled on account of service up to the given date, or whether it means the actual amount contributed on his behalf by the employer up to the applicable date. The House report, part 1, p. 155, is ambiguous. Under (i) on page 155, it states that the limitation "will not apply to employer *contributions made* on behalf of the employee *during* the plan years beginning before January 1, 1970" (emphasis added). But, the next sentence states that the bill "will have no effect on benefits *previously accrued* by employees." It is recognized that the regulations could take a position in this regard. However, because of the importance of the alternatives, it is suggested that a more accurate meaning of the term "benefits accrued" be given in the statute itself.

3. Another substantial problem inherent in the phrase "benefits accrued" is to determine the amount of those benefits, since there are several different appropriate methods. For example, two employees of identical age and salary who enter their respective pension plans at the same time would have different amounts of "benefits accrued" at January 1, 1970, depending on the method of funding their benefits, i.e., entry age normal, attained age normal, etc. If the bill were to levy different

tax burdens depending upon the method of determining actuarial liability or contributions, then the result would be inequitable. The power to provide regulations would not necessarily cure this inequity.

It is submitted that what is needed in the statute is an alternative method of computing "benefits accrued" which, although it may be imprecise, will not be inequitable. What is suggested, specifically, is a simple proration of the amount of the employer-provided benefit depending upon the number of years the employee has been a participant in the plan. Section 331 of the bill, dealing with deferred compensation, provides such a "career average" method for the purpose of that section. It is suggested that that approach be applied to proposed section 402(a)(5) as an alternative method, so that either the career prorated amount or the amount computed according to the regulations, whichever is *greater*, shall be used for this section.

In this manner, the employee would receive a more liberal treatment, since, under several actuarial methods, pension liability and contributions normally increase as the employee's age increases. This "short-cut" method seems appropriate since it would avoid difficult and costly actuarial computations, and, in many instances, different tax consequences for taxpayers whose situations are substantially the same. The use of a proration of benefits over the employment span would also help alleviate the problem of determining "benefits accrued" under pension plans which use the so-called "aggregate" method of funding (i.e., where employer contributions are not allocated to individual employees).

4. It has been pointed out that, by action of section 511 of the bill (which repeals the alternative capital gains tax), an employee who receives a lump-sum distribution from an exempt trust subsequent to July 25, 1969, will be taxed at a higher rate on that lump-sum distribution as compared with a distribution prior to that date. This result would seem to be inconsistent with the carefully drawn effective date provisions of section 515 of the bill, which would leave inviolate employee benefits accrued prior to 1970.

Furthermore, there does not seem to be the usual need here for an early effective date. There are limited avoidance possibilities in the case of distributions under employee benefit plans since the employee does not often have much choice in the timing of lump-sum distributions. Under the circumstances, it is suggested that the July 25, 1969 effective date of section 511 of the bill should not apply to distributions made under section 402(a)(2), as amended, with respect to benefits accrued prior to January 1, 1970.

5. The following comments relate to section 515(b) of the bill (proposed section 72(n)(1)(C)):

a. Subparagraph (C) refers to an employee who has been "a participant in such plan." Language should be inserted at this point to make clear that "such plan" also includes the plan of a predecessor or successor employer, etc., as is now provided in section 331 of the bill—proposed section 1354(b).

b. The same subparagraph refers to "5 or more years." The question is, what is the meaning of the word "years"? Does this refer to a plan year, taxable year of the employee, taxable year of the employer, or calendar year? Or, does it refer to anyone of them as sufficient to meet the 5-year requirement? It is suggested that, in keeping with other provisions of section 515 of the bill, it would be appropriate to use "plan year" in this instance.

c. This same subparagraph also refers to an employee only if he has been a "participant." What is meant by "participant"? Does this mean an employee who is eligible under the plan, eligible but not vested (in whole or in part), or eligible but vested? Many plans have an eligibility waiting period but then, once that has been satisfied, provide credit for all or part of the waiting period as credited service. In this situation, when would the count of years begin for determining when the employee was a participant? In resolving this matter, one approach which should *not* be taken is that now found in section 72(n)(1)(C)(ii); this approach is too restrictive for the purposes of the new 5-year rule for all employees, since, in many pension plans, actual contributions may not be made on account of an employee for one or more years in situations where there is an actuarial surplus by reason of substantial forfeitures. Under present law, section 401(a)(8), forfeitures must be applied against future contributions. However the problem is ultimately solved, it should be done with the precision of language now found in section 72(n)(1)(C)(ii).

Sec. 516. Other Changes in Capital Gains Treatment

Bill pp. 296-300, § 516 [IRC new § 1001(e) and new § 1252]
Other Changes in Capital Gains Treatment

Section 516(a) amends section 1001 to provide that in determining gain or loss on the sale or other disposition of a term interest in property, the adjusted basis of such interest determined under section 1014 or 1015 shall be disregarded.

1. The section as presently drafted covers life and other term interests acquired by gift, bequest or inheritance and, thus, follows the pattern

of section 273 which precludes the amortization of an interest acquired in the manner described. Neither present Code section 273 nor section 516(a) of the bill covers a term interest created by the taxpayer, initially retained by him and then either amortized or sold.

Assume, for example, that a taxpayer transfers a remainder interest in stock to his son or to a charity and retains the right to the dividends for his life. The question has arisen whether he may amortize the life interest on the theory that it is a wasting asset and is not specifically covered by section 273. Whether a term created by the taxpayer may be amortized appears to have been discussed in only two cases. *United States v. Georgia R. & Banking Co.*, 348 F.2d 278 (5th Cir. 1965), and *Illinois Merchants Trust Co.*, 14 B.T.A. 890 (1928) (Dis. Opin.).

Perhaps a retained income interest such as the one described above should not be amortizable. Similarly, perhaps the sale of such an interest should not be given preferential treatment over the sale of an identical interest acquired by gift, bequest or inheritance. Yet, as with present Code section 273, section 516(a) of the bill appears not to preclude the offset of gain from the sale or exchange of a retained life estate by a portion of the basis allocable to it. In cases where assignment of income principles do not require ordinary income treatment on the sale of a retained income interest, such an interest should also be covered by section 516(a) of the bill. If section 516(a) is retained, it might be an appropriate time to amend similarly present Code section 273.

2. The reference in proposed section 1001(e)(3) to "a fee interest" (Bill p. 297, line 16) may provide too broad an exception. Although the exception is fundamentally proper where the underlying fee interest is sold as part of the same transaction, two limitations should probably exist: (i) that the fraction of the fee interest sold should be at least as great as the fraction of the term interest sold, and (ii) that the same fraction of estates and interests intervening between the fee interest and the term interest also be sold.

SUBTITLE C—REAL ESTATE DEPRECIATION

Sec. 521. Depreciation of Real Estate

Bill pp. 300-310, § 521 [IRC new § 1250(j) and (k), amended §§ 1250(a), (b), 167(e) and 381(c)(6)]

Depreciation of Real Estate

The decision to restrict accelerated depreciation for nonresidential housing and to provide additional accelerated depreciation for rehabilitation of low or moderate income housing appears to be a policy decision

based upon national housing goals unrelated to the goals of uniformity and simplification of the Internal Revenue Code.

1. The subsection (k) proposed to be added to section 167 (relating to depreciation) provides for accelerated depreciation of rehabilitation expenditures in connection with "low-cost rental housing." The definition of "low-cost rental housing" contained in section 167(k)(3)(B) refers to dwelling units held for occupancy on a rental basis by families of "low or moderate income as determined by the Secretary or his delegate in a manner consistent with the policies of the Housing and Urban Development Act of 1968." The Housing and Urban Development Act of 1968 and predecessor acts have used the terms "low income," "lower income" and "low or moderate income" for various special programs. The term "low or moderate income" does not appear in the Housing and Urban Development Act of 1968 but does appear in earlier Housing and Urban Development legislation. For these reasons, it is submitted that the definition of "low-cost rental housing" proposed for purposes of the special depreciation deductions to be allowed in the case of rehabilitation expenditures is inadequate.*

2. The inclusion of rules similar to those provided in paragraphs (5), (9), (10) and (13) of section 48(h) for the purpose of new construction begun or contracted for before July 25, 1969 preserves the right of certain transferees to compute depreciation allowances under present law rules. The inclusion of the new rule of section 167(j)(1) in paragraph (6) of section 381(c) without providing for rules just referred to in section 48(h) for used section 1250 property results in a prohibition of the carryover of depreciation methods in the case of used section 1250 property acquired after July 24, 1969. This may be intentional since it conforms to the rule under present law which denies to transferees 200 percent declining balance depreciation even though the transferee's basis is determined by reference to the basis in the hands of the transferor under section 351, 371(a), 374(a), 721 or 731. However, the failure to provide for a carryover of the transferor's 150 percent declining balance depreciation (which is permitted for used property acquired before July 25, 1969) in the case of transfers cov-

* Section 521(a) of the bill (beginning at line 5, page 300) amends section 167 by redesignating subsection (j) as subsection (n) and by inserting after subsection (i) new subsections (j) and (k). This would leave the lettering of subsections to run from (a) through (n) without any subsections (l) or (m). Neither the House report nor the bill make reference to the fact that new subsections (l) and (m) are proposed to be added to section 167 by sections 451 and 705 of the bill, respectively. This may cause technical difficulties if section 521 is retained intact and sections 451 and 705 (or either of them) are rejected before final passage. This should be corrected by adding at the end of line 7, page 300 the following: "to follow subsection (m) (added by section 705)."

ered by section 381(a) is apparently unintended since present law provides for the carryover of 200 percent declining balance depreciation in such cases and, under present law, no carryover provision is necessary to permit the transferee to use 150 percent declining balance depreciation. Under the new rules, unless there is a carryover provision, the transferee will be limited to use of the straight line method of depreciation. This could be remedied by changing section 521(f) so that section 381(c)(6) will be amended to read as follows:

"(6) METHOD OF COMPUTING DEPRECIATION ALLOWANCE.—The acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the depreciation allowance under paragraphs (2), (3), and (4) of section 167(b), or subsection (j), (k), or (m) of section 167, on property acquired in a distribution or transfer with respect to so much of the basis in the hands of the acquiring corporation as does not exceed the adjusted basis in the hands of the distributor or transferor corporation."

Alternatively, the same result could be accomplished by including subparagraph (4) of proposed section 167(j) as an exception in subparagraph (1).

3. Section 312(m) is unclear. A literal reading indicates that the straight line computation is to be made as if the previous year had been computed on the double declining balance method or sum-of-the-year digits method. If this is the intent, then the full cost of the property will not have been recouped by the end of its useful life, as would be the case were a continuing straight line schedule to be maintained. It is assumed that for earnings and profits purposes, gain or loss on disposition will be adjusted to reflect the lesser depreciation allowed, although this is nowhere indicated.*

SUBTITLE E—SUBCHAPTER S CORPORATIONS

Sec. 541. Qualified Pension, Etc., Plans of Small Business Corporations

Bill pp. 313-317, § 541 [IRC new § 1379]
Qualified Pension, Etc., Plans of Small Business Corporations

The American Bar Association has recommended that the $2,500 limitation under H.R. 10 should be removed. (ABA Reports, 1969,

* Since straight line depreciation exceeds the double declining balance method or sum-of-the-years digits method over the greater part of the useful life of an individual property, a fair approach for purposes of the limit on tax preferences might be to adopt the concept of a negative tax preference to take care of the excess in any year of straight line over "liberal" depreciation. This subject is also discussed above in connection with p. 166 of the bill.

Vol. 94, p. —). The extension of such a limitation to subchapter S corporations is inconsistent with this recommendation.

1. So long as the many differences between partnership taxation and subchapter S taxation continue, it is difficult to justify further tinkering which in no way alleviates the difficulties encountered in the past but merely applies yet another layer of complexity.

The proposed section would add a third category of pension and profit-sharing plans and represent a backward step which would widen the gap between overall equality in tax treatment of pension and profit-sharing plan contributions and benefits. Specifically, these problems would result in:

a. Keeping accounts for purposes of limitations on forfeitures (section 1379(a)) and carryovers (section 1379(c)).

b. Recordkeeping by shareholder-employees to obtain relief proposed under section 72. These persons must keep all returns to prove their contributions to the plan in order to arrive at their percentage of exclusion.

c. Where an annuitant dies soon after retirement, deduction for unrecovered section 1379 income comes normally during a low income tax period, whereas the recognition of income has occurred in a high income tax period (section 1379(b)(3)). This is at variance with the stated purpose of the overall reform to equalize the burden of taxation over a period of years.

d. Extensive revision of existing plans of subchapter S corporations will be required as well as plans of any corporation hereafter electing subchapter S.

2. Under the H.R. 10 rule only partners with "more than ten per cent" capital or profits interest are treated as owner-employees. A policy restricting the availability of benefit plans for subchapter S shareholders would seem to relate solely to major shareholders. Hence, it would seem that the 10 per cent limitation found in H.R. 10 would be more logical than the 5 percent stockholder rule proposed.

3. Stock bonus plans have been thought not possible for subchapter S corporations. Unless the intention of Congress is to open the way for such plans, in some new provisions dealing with subchapter S, it may be well to delete references to stock bonus plans and make the section applicable only to profit-sharing plans.

4. Section 401(a)(8) provides that in a qualified pension plan, forfeitures must not be applied to "increase" the employees' benefits. In proposed section 1379 (Bill, line 12, p. 314) forfeitures would not be allowed to "inure to the benefit of" a shareholder-employee. If there is a difference in the meaning of these terms, it should be explained. If not, use of the same language would be preferable.

At line 9, page 314, the phrase "forfeitures attributable to contributions" seems incomplete. The phrase "forfeitures of benefits attributable to contributions" would be better.

At line 8, page 316, the bill fails to identify the person entitled to the deduction. It would seem better to delete "then there shall be allowed as a deduction" and insert "then the employer may deduct."

TITLE VII—EXTENSION OF TAX SURCHARGE AND EXCISE TAXES; TERMINATION OF INVESTMENT CREDIT

Sec. 704. Amortization of Pollution Control Facilities

Bill pp. 339-347, § 704 [IRC new § 168]
Amortization of Pollution Control Facilities

1. Section 168(a) permits the taxpayer to elect to begin the amortization period either with the month following the month in which the facility was completed or with the succeeding taxable year. Although the section provides that the amortization deduction "with respect to any month shall be in lieu of the depreciation deduction . . . for such month," it does not make it clear whether a taxpayer electing to begin the amortization period with the succeeding taxable year is entitled to depreciation deductions under section 167 during the year in which the facility was completed. This uncertainty should be resolved.

2. The certification process will undoubtedly be time-consuming. There is no indication as to what a taxpayer is to do if certification is not completed by the due date for filing his return. In addition, property may not be certified to the extent it appears that "by reason of profits derived through the recovery of wastes or otherwise in the operation of such property, its costs will be recovered over its actual useful life . . ." Section 168(e)(2). The term "profits" is not defined. Ordinarily, this would mean an excess of receipts over expenses including an allowance for the recovery of costs in the form of depreciation. Under this definition of "profits," costs would have to be recovered twice to prevent certification. Also, it is not clear whether some portion of costs could be certified if there were a partial recovery through "profits." In any case, certification depends upon a projection of "profits" which may not in fact be recognized.

If the certifying agency follows literally the requirements of section 168(d)(1)(B), certification will be very time-consuming and complex, and may involve difficult questions of financial and cost accounting. The cost of adequate presentation may dissipate the proposed benefits in many cases. It is suggested that the opportunity for abuse is not great

and does not justify this complexity. The requirements of subsection (d)(1)(B) should be eliminated.

3. The House report's general explanation at page 198 indicates that additional first year depreciation under section 179 could be claimed even though the facility is amortized under section 168. It is doubtful that the proposal accomplishes this result. Section 179 allows an additional deduction only where a deduction is permitted under section 167. The deduction under section 168 is in lieu of a deduction under section 167. If it is intended to permit a deduction under section 179 as stated in the House report, that section should be appropriately amended.

4. Section 704 of the bill classifies pollution control facilities as section 1245 property. Consequently, adjustments to basis reflecting depreciation or amortization will result in ordinary income to the extent of any gain upon disposition. Under section 168(d)(4), a building that is "exclusively a treatment facility" may qualify for the amortization deduction. Such a building would therefore become subject to section 1245 rather than section 1250. There appears to be no reason why a building qualifying as a "treatment facility" should be subject to the provisions of section 1245 rather than those of section 1250.

The stated purpose of section 168 is to provide an incentive for taxpayers to invest in pollution control facilities. It is not clear why this purpose is not equally well served by investment in either new or used facilities. Nevertheless, the proposal grants the incentive only with respect to investment in new facilities. The fact that such a distinction existed under the investment credit—which was designed to achieve a quite different purpose—is not sufficient reason to adopt that distinction in this instance.

Section 704 does not deal with the question of salvage value. Presumably, salvage value is not to be taken into account as to the portion of the taxpayer's investment subject to amortization. The section also does not state whether accelerated depreciation is intended to be available after termination of the election. However, these deficiencies are also present in existing section 168, dealing with amortization of defense facilities, and presumably the rules to be developed under that section will apply.

5. Section 168 neither defines "adjusted basis" nor specifies the treatment to be accorded to capital additions to qualifying property. These matters should be dealt with in the statute, as was done in the existing section 168 dealing with amortization of defense facilities.

TITLE VIII—ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS

Sec. 802. Fifty-percent Maximum on Earned Income

Bill p. 354, § 802 [IRC new § 1348]
Fifty-Percent Maximum Rate on Earned Income

Section 802 of the bill adds section 1348 to provide in general that earned income is to be subject to a maximum tax rate of 50 percent.

The rule for calculating the maximum tax as set forth in section 1348(a) appears to have been drafted backwards. The references in the bill to "the lowest amount of taxable income on which the rate of tax under section 1 exceeds 50 percent," should be references to "the *highest* amount of taxable income on which the rate of tax under section 1 *does not exceed* 50 percent." See House report, part 2, p. 139.

The definition of "earned income" for purposes of the maximum provision excludes deferred compensation. This would seem to be an unwarranted discrimination against this method of compensation. It would work with particular harshness where the 50 percent limitation would have applied if the income had been paid when earned, and where, therefore, the throwback rule provided in proposed section 1354 is not applicable because it would not result in a higher tax than treatment of deferred compensation as income of the year in which it is received.

The provision has been drafted so that each increase in earned income pushes unearned income into a higher bracket. Thus, the effective rate on an additional amount of earned income will be 50 percent plus the increase it produces in the tax payable on the taxpayer's unearned income.* The formula under proposed section 1348(a) might be revised to provide that a taxpayer's unearned income plus his earned income up to the 50 percent tax bracket shall be taxed at normal graduated rates, with the excess of his earned income being taxed at 50 percent. If his unearned taxable income (unearned income less his deductions) standing alone would take the taxpayer past the 50 percent bracket, such income would be taxed at the normal rates and all of his earned income should be taxed at 50 percent.

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* If the taxpayers in the example at page 140 of the House report, part 2, had $25,000 more earned income, their tax for 1971 would go up $13,326, not $12,500 as it would if the intent is to limit the tax burden on earned income to 50 percent.

Bill pp. 356-358, § 803(a)(2)(E) [IRC amended § 1(b)(3)]
Intermediate Tax Rates; Surviving Spouse Treatment

Section 803(a)(2)(E) provides that for the purpose of determining whether an individual who has been married is entitled to the new "intermediate tax rate," only the last marriage shall be considered. This provision could result in a hardship where a surviving spouse has remarried and the second marriage has been terminated by annulment or divorce.

Bill pp. 366-368, § 805 [IRC amended § 3402]
Collection of Income Tax at Source on Wages

The provisions of this section are intended to bring the withholding tables in line with the new income tax rates prescribed by section 1 and the low income allowance.

1. The proposed amendment to section 3402(a) requires that the tables to be prescribed by the Secretary be the same as the tables contained in this subsection as in effect before August 1, 1969, except that they be computed on the basis of the rates prescribed by section 1. The present statutory framework is too rigid for practical application where payrolls are computerized. This fact has been recognized in Revenue Ruling 66-328, 1966-2 C.B. 454. The necessary flexibility would be achieved if in line 17 of page 366 of the bill the word "substantially" were inserted after the words "shall be" and before the words "the same."

2. The withholding allowance provisions of section 3402(m) are keyed to the value of a withholding exemption and the percentage rate of the standard deduction. The current value of a withholding exemption and rate of the standard deduction are revised by sections 801-805 of the bill. In 1972 the applicable percentage for the standard deduction will be 15 percent of adjusted gross income. Withholding tables will be structured on the basis of an annual value of $600 for each withholding exemption. If section 3402(m) is not amended the following result will occur where an unmarried individual with adjusted gross income of $6000 is entitled to $1500 in itemized deductions:

A. Taxable income will equal $6000 less $1500 less one exemption of $600 for a total of *$3900.*
B. The new withholding tables will compute an amount for withheld

tax on the basis of a taxable income of $6000 less $1100 (low income allowance) less $600 for a total of *$4300.*

C. The taxpayer will be entitled to one withholding allowance $\left(\frac{\$1500-\$600}{\$700}\right)$ under section 3402(m) and by taking advantage of the allowance (which is treated as if denominated an exemption) will have withheld an amount of tax on the basis of a taxable income of $6000 less $1100 (low income allowance) less $1200 (2 exemptions) for a total of *$3700.*

This amount is $200 less than his actual taxable income. Thus, by using the present withholding allowance provisions the taxpayer would be able to reduce his withholding below the amount of his tax liability.

SUMMARY
STATEMENT OF NATIONAL ASSOCIATION OF MANUFACTURERS
ON
H.R.13270, "TAX REFORM ACT OF 1969"

October 3, 1969

The most serious drawback of H.R. 13270 is its negative implications for capital formation and real growth of the economy. This is apparent in the provisions to repeal the 7% investment credit, increase the corporate capital gains tax, repeal the alternative capital gains tax for individuals, drastically restrict the depreciation treatment of commercial and industrial real estate, and change the tax treatment of natural resource industries. The cumulative impact of these provisions could be a serious blow at domestic investment and our competitive stance abroad.

The most obvious means to help assure adequate capital formation for the future is a significant cut in the corporate income tax rate. We recommend a cut of at least five percentage points spread over a five-year period from 1971-1976. A legislative commitment to rate reduction is more important than the specific timing.

The proposal for the tax treatment of deferred compensation would add great complexity to the Code, even though no abuse has been shown and there is slight revenue effect. The NAM also opposes sections of the bill relating to lump-sum distributions and the foreign tax credit. Good, but incomplete, starts are made in the bill with respect to moving expenses, taxation of cooperatives and pollution control.

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TESTIMONY ON ALL TAX BILLS INTRODUCED

by SENATOR TED STEVENS

October 2, 1969

Thank you for giving me this opportunity to testify before this committee on behalf of this important tax legislation.

There has been a great outcry from the American people for tax reform. If there is any one common element of tax reform which is a consistent part of this cry, it is for greater equality in the distribution of the tax burden. The House bill, while containing several excellent provisions toward this goal, leaves several important inequities untouched. I have introduced several bills which would help to correct these deficiencies.

The first bill I would like to call to this committee's attention is S. 1908. This bill has two main purposes. The first would raise the personal exemption from its present $600 level to $1,000. Personal exemptions benefit, primarily, the poor and middle income tax paying families, and these families are, in my opinion, the most heavily burdened by our present income tax. In 1913, when the income tax became a permanent part of our economic fabric, the dollar was worth far more than it is today, but the personal exemption was $3,000 and was never less than $1,000 until 1940. It was then gradually reduced during the years of World War II to $500. It was last increased in 1948--when a dollar was worth more than twice what it is today--to its present $600 level. In other words, in terms of today's dollars, the personal exemption of 1948 was worth over $1,200. Thus, the first purpose of S. 1908 would help to restore the balance in our graduated tax system that inflation has destroyed.

The second purpose was to help to correct a long-standing inequity in the income tax. This provides for an increase in the personal exemption in those areas of the country where the cost of living exceeds the national index. In some regions of our country the cost of living is 10, 20, even 50% higher than the national index. It is 8% higher in San Francisco, 11% higher in New York

of business, the over-all burden would be equivalent to a 12% increase in corporate tax liability at current levels. And while the House bill provides substantial tax reductions for lower- and middle-income individuals, no rate reduction at all has been provided for the corporate sector.

It should be emphasized that these estimates, based on "straight-line" projections of revenues without accounting for normal economic growth or inflation, undoubtedly understate the true damage to be done to the corporate sector. In fact, we have serious doubts about the estimates of the bill's revenue shifts throughout, owing to the extreme complexity of so many of its provisions.

Thus, we certainly concur with Secretary Kennedy that the bill is "over-weighted in favor of consumption" and " could impede economic growth in the years ahead by curtailing the incentive to make productive investments."

The anti-capital formation thrust of this bill is most obvious in the provision to repeal the 7% investment credit. We already have presented our views on this before your Committee, and in recognition of your instructions, will not dwell on the issue. However, we would like to point out that the proposal to repeal the credit was made originally last spring in response to short-term economic circumstances but is now part of a tax reform program involving a massive redistribution of tax burdens on a long-term basis. It is joined by several other provisions of H.R. 13270 which would have a similar effect, including an increase in the corporate capital gains tax and repeal of the alternative capital gains tax for individuals, a drastic restriction of the depreciation treatment for commercial and industrial real estate, and proposed changes in the tax treatment of natural resource industries. Whatever the arguments for and against these provisions on an individual basis, their cumulative impact would be a serious blow to domestic investment, an inducement to send funds abroad, a weakening of our competitive stance abroad, and a stunting of our economic growth.

We recognize that in the particular circumstances of late 1969, capping a long boom in business capital spending, large increases in such investments are not needed. But the boom will not last forever. In fact, there are plenty of signs right now that the boom is petering out -- that the long business expansion in general is weakening and that capital spending in particular shortly will be on the wane. Therefore, we should be thinking of the kind of tax system that will be appropriate to the economic conditions that will prevail <u>for the long term after the boom is over</u>.

We feel strongly that this tax system should not penalize domestic capital formation -- growth of which is essential to provide adequate jobs in the 1970s for the large number of new entrants into the labor supply. Anyone who has even a casual knowledge of interest rate trends will recognize the worsening, world-wide capital shortage today, and that regardless of the fate of the investment credit, we will be in great need of a favorable climate to assure an adequate capital supply in the 1970s.

The most obvious means to help assure this climate is to provide some general corporate tax relief in the form of a significant cut in the corporate income tax rate. Many studies have indicated the perverse effect of the high corporate income tax on capital formation, efficient allocation of resources and economic growth. It is a tax of uncertain and varying incidence, the only certainty being that the real burden is not borne by corporations at all, but by live human beings who may in varying degrees be investors, workers or consumers.

The economic distortions created by any tax tend to be proportional to the rate of the tax. Lowering the corporate rate in general would reduce the distortions. Therefore we strongly urge your Committee to recommend a significant

reduction in the corporate income tax rate to take effect along with the cuts you propose for individual taxpayers.

The Administration has proposed a cut of one percentage point in the corporate tax rate for 1971 and another percentage point for 1972. This would help redress the imbalance of the bill, but still would mean a very substantial increase in tax burdens on the corporate sector. We recommend a cut of at least five percentage points to be spread over a five-year period 1971-1976. When fully effective, this would mean a reduction of approximately $4 billion in corporate income taxes, substantially less than the relief proposed for individuals under H.R. 13270. Of course, the extent to which this could be characterized as true "relief" for the corporate sector would depend on how Congress acts with respect to other provisions of the bill. Repeal of the investment credit, for example, would almost completely offset the corporate tax reduction that we propose.

As pointed out by Secretary Kennedy, we don't know how stable the economy will be in the early 1970s, and large net tax reductions bunched over a two-year period, as provided in H.R. 13270, could have considerable inflationary consequences. The important thing in our opinion is not the specific timing but a legislative commitment to rate reduction to assure adequate capital formation over the long-term.

II - CAPITAL GAINS

From a revenue standpoint, the most significant provision of H.R. 13270 in the capital gains area would remove the alternative tax rate for individuals. This would result in an estimated $360 million revenue increase on an annual basis.

According to the Report of the Ways and Means Committee, this provision is justified to bring capital gains treatment more in line with the progressive rate structure. In fact, coming on top of the proposal for a minimum income tax (or LTP) and allocation of deductions, the thrust of this bill emphasizes the ability-to-pay

principle to the exclusion of everything else, including simplicity and possible basic economic dislocations. No consideration is given to the impact of eliminating the 25% ceiling on the provision of risk capital as an essential ingredient for the growth of many new enterprises, and as a crucial motivator of effort in our society. Certainly before the ability-to-pay principle is extended in this manner, more serious consideration should be given to possible economic and other effects, and indeed, to whether or not capital gains should even be considered part of regular income taxation.

H.R. 13270 also proposes extension of the six-months holding period to one year for qualification for long-term capital gains treatment. Whether or not your Committee adopts this proposal, we urge you to consider lowering the existing capital gains rate schedule for productive investments held over a substantial period, say ten years or more. Appreciation in shares of closely-held firms, for example, where there is a clear-cut case of capital transfer rather than receiving of income,should receive more favorable treatment, and the drift of H.R. 13270, if enacted in a form close to what has been proposed, would greatly increase the need for such treatment.

Alternative Corporate Capital Gains Rate

The case for moderate taxation of corporate capital gains is essentially the same as that for individuals' capital gains -- to encourage the provision of risk capital for the expansion of new enterprise or re-invigoration of existing businesses. In view of the obvious need for such treatment in a dynamic enterprise economy, it is extremely difficult to follow the rationale for raising the alternative corporate capital gains tax from 25% to 30% on income over $25,000 as provided in H.R. 13270.

As stated in the Ways and Means Committee Report, H.R. 13270 would eliminate the alternative tax for individuals raising the maximum rate to 32.5% (after 1972) and, therefore, "a comparable adjustment should be made to the corporate alternative tax." But even if one accepts the bill's case for extending the ability-to-pay

principle to individuals' capital gains, this is hardly grounds for heavier taxation of the corporate sector accounting for well over 90% of all net corporate capital gains.

Since, as the Report acknowledges, corporate incomes are subject to only a one-step graduation at $25,000, while individuals are subject to 25 steps of graduation, the question of ability to pay is involved in corporate capital gains only by the most tortuous reasoning. Certainly, a one-step graduation in corporate income taxation was never intended to serve as a model of progression to penalize larger enterprises.

Adoption of the proposal would raise the corporate capital gains rate to substantially more than half of the regular corporate rate of 48% (exclusive of the surcharge). Not even under H.R. 13270's punitive measures for treatment of individuals' capital gains would any individual pay a capital gains rate more than half his top regular rate.

We see no reason why this proposed provision should be considered a tax "reform" or how the present system of corporate capital gains taxation could be considered an abuse. We are at a loss to understand why it has been included in this general tax reform bill except, of course, to provide additional revenue without regard to the economic consequences. We strongly urge your Committee to reject this short-sighted approach and recommend against increasing the corporate capital gains tax.

Lump-Sum Distributions

The House-passed bill is defective, we feel, in regard to the proposal to change the rules governing the taxation of lump-sum distributions from qualified employees pension, profit-sharing, stock-bonus, or annuity plans.

Under present law, distributions to an employee from a qualified plan are taxed to the employee when he receives them. Generally speaking, the distributions

are taxed at ordinary income rates, based on the employee's total taxable income in the year of receipt. An exception to this rule was enacted by Congress in 1942. It provides that when an employee receives his total distribution within a single taxable year, the amount of the distribution will be taxed as long-term capital gain. This exception was enacted in recognition of the inequity of taxing as ordinary income amounts which are attributable to many taxable years.

The House-passed bill proposes to change the present law regarding lump-sum distributions so that all amounts received by the employee which are represented by the employer's contributions over the years will be taxed as ordinary income. Capital gain treatment would be limited solely to the net taxable portion of the distribution in excess of the employer's contribution. The amount represented by the employee's contribution is, of course, not taxed since it represents his investment in the plan and is thus a return on his investment. Under the House proposal, the portion of the distribution treated as ordinary income would be averagable under a five-year forward averaging provision.

We do not believe that the House proposal to change the taxation of lump-sum distributions should be enacted. The present law has been in effect for 27 years and has worked well to reflect the long period of time during which employees accumulate benefits under qualified plans. At least five million employees currently are accumulating such benefits. The present law also has the advantage of being easily understood by taxpayers and simple to administer. In addition, there has been no showing that the present law has been abused, and neither the Johnson nor the Nixon Administration advocated changes in the present rules.

Perhaps the primary defect of the House proposal is its extreme complexity. In fact, it is inconceivable that the ordinary taxpayer would be able to compute his tax liability under the proposed rules without assistance of a tax consultant.

Several steps will be necessary in each computation and much of the information necessary for the computation will not be readily available to the employee. Thus, it is certain that the cost of compliance and administration will be significantly higher under the proposed rules than under current law.

Another defect of the House proposal is its failure to adequately take into account the fact that many employees accumulate benefits in qualified plans for as long as 30 years or more. The five-year averaging device proposed by the House is clearly defective since its maximum effect would be a five-year spread out and it would not operate until five years after the employee has received the lump-sum distribution and paid tax based on his income in the year of the distribution. In other words, under the House proposal a taxpayer would pay a tax in the year of distribution based on the full taxable amount of the distribution and his other taxable income, and he would be required to wait five years before seeing whether the so-called "averaging" device entitles him to a refund for overpayment of tax. The taxpayer would thus be deprived of the overpayment during the five-year period, and would have to go to the trouble of filing for a refund of taxes which he never in fact owed. The defect of this rule is even clearer when one considers that the taxpayers to which it applies will in many cases be retired employees who may well need the money in order to provide for their retirement. Certainly, if the Congress does change the rules governing lump-sum distributions, we would advocate that averaging be permitted on a prospective as well as a retroactive basis.

In analyzing the House proposal, it is also necessary, we feel, to consider two other provisions of the House bill. The first of these is the proposal to remove the 25% maximum alternative rate on capital gains of individuals. This proposal will, when coupled with the proposal regarding lump-sum distributions, deal a double blow to employees receiving lump-sum distributions, for this would conceivably result in a higher tax rate being applied to even that portion of the

distribution which will continue to be taxed as capital gain. In view of this, we feel that if the Congress does adopt the House proposals that it retain the maximu 25% alternative rate at least in this instance.

The second House proposal which should be considered, we feel, is the provision to place a 50% ceiling on the tax rate on earned income. As presently drafted this provision does not apply to lump-sum distributions, and thus although treated by the House as earned income, such distributions could conceivably be taxed at rates higher than 50%. There does not seem to be any rationale for this discriminatory treatment, and we would hope that if the House's proposal on lump-sum distributions is adopted, such distributions will be made subject to the 50% limit on earned income.

III - DEFERRED COMPENSATION

One of the primary concerns of the NAM regarding the House-passed bill is its proposed change of the rules governing the taxation of deferred compensation not involving restricted stock.

Of all the changes proposed by the bill, this is perhaps the most striking example of the addition of extreme complexity to the Code even though no abuse has been shown and where the effect of the change could well reduce rather than increase federal revenues.

Under present laws, if an employee and an employer contract that the employee's services will be compensated both during and after his tenure with the employer and the amount which the employee is to receive after separation is not at his disposal until that time, the employee is not taxed until he actually receives the income. When he receives the income, the employee is taxed at ordinary income rates based on his total net income in the year of receipt. No income escapes taxation, no capital gains treatment is involved, and the employer is not allowed a deduction until the income is actually paid out. The current method of taxing such income

has been upheld in many court cases, and was officially sanctioned by the Treasury Department in 1960 in Revenue Ruling 60-31. Innumerable companies have built their compensation structures in reliance on these authorities

The House proposes to drastically alter the rules governing the taxation of deferred compensation. Under its proposal, deferred compensation would continue to be taxed in the year of receipt, but the amount of the tax would be computed as if the employee had received the deferred compensation during his service with the employer. This fictional approach would, as far as the amount of the tax is concerned, result in the employee paying tax as if he had the use and benefit of the income during the time that it was being retained by the employer. This fundamental break with traditional tax principles would, we believe, have several negative results.

One of the obvious difficulties with the House's proposal is the problem of compliance and administration. Although some of the details of the proposed rules are to be developed in Treasury Regulations, the basic structure of the proposal is contained in the House bill. This structure is both historic in effect and monumental in complexity. It provides that deferred compensation in excess of $10,000 received during a taxable year will be subject to a so-called minimum tax, which is arrived at by looking back to the employee's taxable years during his service with the employer paying the deferred compensation. The minimum tax is to be the lower of two alternative amounts. The first alternative amount of minimum tax is the aggregate increase in tax resulting from adding to the employee's taxable income for each taxable year in which the excess is deemed to have been earned, the portion of the excess over $10,000 deemed to have been earned in that taxable year. For this purpose, the deferred compensation is deemed to have been earned ratably over the employee's entire period of service with the employer. Under the second alternative, an average increase in tax is computed by adding to

the employee's taxable income for the three taxable years for which his taxable income is highest during the last ten years of the earning period, the portion of the excess over $10,000 deemed to have been earned in those three years. This average increase is then multiplied by the number of taxable years in the earning period, to determine the total tax. The mere statement of these rules clearly indicates the problems which would arise in complying with and in administering the House proposal.

An even more basic difficulty with the House proposal is the impact the proposal would have on the entire concept of deferred compensation arrangements.

Deferred compensation arrangements antedate the income tax laws, and are used by thousands of companies, both large and small. A 1969 report of the National Industrial Conference Board, Inc., based on data obtained from a large sampling of firms, indicates that 51% of surveyed manufacturing companies and 65% of surveyed retail companies (most of which, of course, are relatively small firms) have deferred compensation programs.

There are many reasons for the use of deferred compensation plans other than tax reasons. From the employee's point of view, a deferred compensation arrangement offers a means of averaging his compensation and providing for his retirement period. The concern is not primarily to have these earnings taxed at lower rates, but rather to provide a "spread-out" of earnings over the actual rather than economic life of an employee.

From the point of view of the employer, deferred compensation arrangements have basic ~~defects~~ benefits in that they permit the employing company to retain amounts that would otherwise be paid out as current compensation and, when the amount of the deferred compensation is based on the market price of the company's stock or the amount of dividends paid on the company's stock, there is a continuing incentive to the employee to improve the profitability of the company. The flexibility available to an employer through the use of deferred compensation

plans increases the likelihood that he will be able to motivate employees successfully. The variety of interests and needs of employees is virtually as great as the number of employees. To say, as does the Committee Report of the House, that deferred compensation is primarily used by the already highly paid is merely another way of recognizing that it is a useful compensation arrangement.

The benefits available to companies through the use of deferred compensation plans are applicable to small companies as well as large. In some respects they are especially important to small and medium sized companies who cannot afford large fixed salary commitments and who face economic uncertainties and possible future financial difficulties. In fact, a deferred compensation plan is one of the primary ways a small company can attract and retain competent executives and technical personnel who might otherwise prefer a larger current salary from a bigger company.

Enactment of the House proposal, we believe, would result in the termination of the use of deferred compensation plans. If employees are going to be taxed as if they had received income in earlier years, many will naturally wish to receive the income in the form of current compensation. One result of the termination of deferred compensation plans, we believe, would be to encourage the piracy of employees by those companies who are willing and able to pay higher current compensation, thus interfering with stable long term employment relationships. Another result, we believe, would be a reduction in federal revenues. The House Committee Report estimated a slight gain in revenues from the adoption of this proposal. However, this estimate was based on the assumption that deferred compensation arrangements would be continued in their present form, with the only change being that the deferred compensation would be taxed at the presumably higher tax rates of an employee's earning years. As indicated, we do not feel that this is a valid assumption. To the contrary, we feel that the House proposal

would result in a shift to current compensation arrangements or to more extensive use of qualified pension and profit-sharing plans. In either case, the corporation would be entitled to a current deduction in the full amount paid out as salary or contributed to a plan. Since the corporate tax rate will undoubtedly be higher than the average of the tax rates of the applicable employees, and since in the case of qualified plans taxation of the employees will be deferred until receipt of the benefits,the result could be a loss in federal revenues.

Another difficulty with the House proposal is its inconsistency with the provision in the House bill which would limit the marginal tax rate on earned income to 50%. As it passed the House, this provision would not apply to deferred compensation. Thus, deferred compensation would in effect be subject to prejudicial tax treatment, since unlike current compensation it could, under the House bill, be taxed at rates higher than 50%. There is no rationale for this prejudicial treatment and it would clearly increase the likelihood that the use of deferred compensation arrangements would be terminated.

In sum, we feel that the House proposal would add a complicated and fictional rule to an already complex tax code, and would change the law in an area where no abuse has been shown. Deferred compensation arrangements are firmly based in the economy, there are many non-tax reasons for their use, and no income escapes taxation. Furthermore, unlike the House proposal, the current method of taxing deferred compensation is soundly based in tax theory. Virtually all employees are cash basis taxpayers, and under the cash method of accounting, income is not taxed until it has been actually or constructively received. Yet, the effect of the House proposal would be to tax employees receiving deferred compensation as if they had received the income during earlier years. For all of these reasons, we agree with the Administration that there should be no hasty legislation in this area.

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IV - REAL ESTATE DEPRECIATION

Section 521 (a) of the bill would deny the use of accelerated depreciation methods to new depreciable real property (other than residential) and would require that the straight-line method be used for such used property.

The report of the Ways and Means Committee indicates that its purpose is primarily to eliminate the trading in losses and opportunities for tax avoidance which are primarily of benefit to the real estate operator. However, although the committee's purpose hardly applies, even depreciable real estate constructed or acquired for use as an integral part of manufacturing and other business and industrial operations would be included under these very broad provisions. Non-speculative properties of this type, whether factories, warehouses, or office buildings, are essential to the modernization of industrial capacity and, therefore make a constructive contribution to increased productivity and real economic growth.

The haste with which this section was conceived is clearly evident in that it follows by only a couple of months the Administration's announced plans to explore liberalization of depreciation allowances for productive facilities. We strongly urge your Committee to revise Section 521 (a) to ensure that accelerated depreciation methods continue to apply to real estate used for its intended function by the owner in the active conduct of his trade or business.

V - DEPLETION

H.R. 13270 would reduce rates of depletion allowance for various minerals, most notably that for petroleum from 27½% to 20%. We believe this would be unwise. The continued existence of a sound extractive natural resouces industry requires recognition in the tax laws that this industry is unique in that it exhausts its assets in the course of operations. Currently, exploration for, and discovery and development of, new mineral deposits are becoming even more difficult, more costly,

and financially more hazardous. Therefore, we believe that, not only should adequate provision be made for the current deduction of research, prospecting, exploration and development costs, or deferment at the election of the taxpayer, but percentage depletion allowances at not less than existing rates should be continued. We strongly urge the Committee to delete from the bill provisions for reductions in the rates of percentage depletion allowances.

VI - FOREIGN TAX CREDIT

Foreign business activities play an important role in U.S. foreign economic relations and policies. Such activities abroad are exposed to greater risks than are business activities in the United States and must compete with foreign enterprise often subsidized and often subject to lower basic tax rate. Consequently, business income earned abroad by United States enterprises should be afforded tax treatment which gives due consideration to the additional factors involved.

Nevertheless, not a single one of the many suggestions made by industry representatives and others for relief of unnecessary tax burdens and inequities under existing law in this area was picked up in H.R. 13270. Instead its provisions continue the trend, evident since 1962, toward harsher treatment of foreign source income.

Section 431 provides a recapture rule in the event that U.S. taxpayers sustain foreign losses which are taken into account in computing their worldwide taxable income tax for U.S. income tax purposes. In general, the rule as contained in the House passed bill would affect all U.S. taxpayers who use the per-country limitation for foreign tax credit purposes. Under the recapture concept, any reduction in taxable income produced by a foreign source loss in one taxable year would be offset in later taxable years by reducing the amount of the foreign tax credit that would otherwise be allowable under existing law when income is derived from that foreign source by the U.S. taxpayer.

In one manner of speaking, Section 431 seemingly indicates there is no justification for recognizing as a creditable tax an income tax paid to a foreign country which does not allow a net operating loss carryover. Historically, the U.S. has never required that the income tax system of a foreign country exactly parallel the U.S. system in order for the tax credit to be allowable since it recognized that income tax systems of other countries vary, and necessarily will continue to do so, because of the manner in which they were developed and the likelihood of the continued existence of most foreign countries as separate sovereigns. In actuality, there is no need to reduce the allowable foreign tax credits in these types of cases because the net effect of an income taxing system of a foreign country which fails to allow a net operating loss carryover in the computation of their income tax means that the effective rate of tax imposed by such country is higher than it would have been had such a loss been recognized.

If the proposed change were enacted, it would result in discrimination against those taxpayers operating in foreign countries whose tax laws did not parallel in principle the provisions of the U.S. law. Furthermore, the mechanics of the proposed provisions can result in apparently unintended effects over and above the penalty imposed upon those companies operating in countries not allowing loss carryovers. For example, even where a company operates in a foreign country allowing loss carryovers, it is possible that the mechanics of the new provision would result in additional U.S. taxes. Assume, for instance, that a loss in a foreign country having the same rate as the U.S. were offset exactly in the second year and there was no foreign tax paid in the second year. At this point the U.S. has recaptured the so-called tax benefit of the first year in full. In year three a foreign tax is paid but in this year the limitation on allowable foreign tax credits is reduced by 50% of the loss in year one since only 50% of such loss was used as a reduction of the foreign tax credit limitation in year 2. In year 3,

therefore, the taxpayer would not be able to recover the full amount of the foreign income taxes paid by him notwithstanding that the U.S. had already recaptured the full amount of the so-called tax benefit of the first year.

In addition, the effect of this proposed change would be to penalize new business activities abroad, in that losses are often incurred for the first several years of such activities. We believe that any venture which would take several years to become profitable should not be made less attractive by discriminatory tax treatment.

Section 432 provides for a separate country-by-country FTC limitation with respect to "foreign mineral income" derived from within any foreign country or possession of the U.S., or any agency or instrumentality thereof, that (a) requires the payment of any bonus or royalty with respect to property which gives rise to "foreign mineral income," (b) holds substantial mineral rights with respect to such property, or (c) imposes any income, war profits, or excess profits taxes on such income at an effective rate higher than on other income.

The stated justification for the addition of this section is that it is difficult to distinguish royalties paid to foreign governments from income taxes paid to the same governments. But the facts do not support this. As in the case of the United States Government, foreign governments which own mineral properties collect royalties for the right to carry on extractive operations and impose income taxes on profits derived from those operations. The same criteria that distinguish the royalties which the U.S. Government collects in its role as an owner of mineral rights from the income taxes which it collects from mineral operators carrying on operations on Government-owned lands, are available to make this determination when the operations are carried on in a foreign country. We note that Assistant Secretary Cohen when he appeared before your Committee early in September stated that the Treasury Department did not feel that the characterization of foreign

taxes on mineral income in excess of the U.S. rate as royalties was justified.

Section 432 is discriminatory in that it denies the use of the overall limitation in computing the allowable foreign tax credit to a single industry, i.e., the mineral industry. The concept which justified the addition of the overall limitation to the Code was based upon the fact that many U.S. companies treat their entire foreign operations as an integrated operation separate from a U.S. operation and that in such cases it was appropriate to permit such companies to compute the foreign tax credit on the basis of income from all sources outside the U.S. rather than on a country-by-country basis.

To single out one industry and deny it the availability of computing the foreign tax credit on an overall basis is in effect a precedent for dissecting a single business operation into its various component parts rather than treating it as an economic unit. From a practical point of view, section 432 fails to recognize that production in one foreign country is of little avail if it cannot be processed and marketed in other foreign countries. Thus, the effect of the proposal is to deny the use of the overall foreign tax credit concept in those situations where the overall business operation (producing, processing, transporting and marketing) is taxed at various rates by various foreign countries, which is exactly the type of situation for which the overall limitation was enacted by Congress.

Accordingly, we recommend that your Committee reject the addition of Sections 431 and 432 to the Code.

Limitations of space prevent us from detailing industry's case for changes in the application of the foreign tax credit. However, at this time we would emphasize two points.

1) Where the business form of a foreign operation is a foreign corporation owned by a U.S. corporate parent, an indirect credit under Section 902 with respect to dividend income received by the parent is allowed for foreign income taxes paid

by the foreign corporation and attributable to the dividend, provided that prescribed percentage of ownership tests are met. Those tests require that the U.S. parent own at least 10% of the voting stock of a first-tier foreign corporation, and that the first-tier foreign corporation own at least 50% of the voting stock of a second-tier foreign corporation. No provision is made for lower tiers.

Since the 10% - 50% ownership rules became law in 1951, the great growth of U.S. corporate investments abroad has been accompanied by increasingly complex foreign rules, frequently preventing U.S. investors from owning as much as 50% of the stock of foreign corporations. There are also many cases involving lower tier companies resulting from acquisitions and business requirements.

We recommend that, to relieve the inequity of the present ownership requirements, the indirect credit be allowed with respect to any second or lower tier foreign corporation at least 5% of the voting stock of which is owned indirectly by a U.S. corporation.

2) The other major point involves the effect of the income tax surcharge on the foreign tax credit. The present 10% tax surcharge, which when proposed was consistently called a temporary tax on a tax, was generally understood to apply equally to all taxpayers, regardless of the nature of their income. This important equity objective is achieved only by imposing the surcharge as the last step in the tax computation.

As it was enacted, however, the surcharge is imposed in an intermediate computation before the foreign tax credit, instead of on the final tax, with the result that corporate taxpayers having foreign source income bear a tax surcharge having a disproportionately high effective rate. This is not only inequitable, but also questionable under the foreign tax conventions. We recommend that the law be amended to limit the tax surcharge to 5% (or whatever rate is determined after 1969) of the tax which would have applied in the absence of the surcharge.

VII - MOVING EXPENSES

The House-passed bill recognizes that more equitable tax treatment of moving expenses is necessary. Labor mobility helps both the employer requesting the move and the economy as a whole. But it almost always inconveniences the individual involved and his family. For them -- the half million or more families involved in employment-related moves each year -- the least that can be done is to insure that the tax effect is neutral.

The recognition of the need to go beyond a "bare-bones" definition of moving expenses to include so-called "indirect" expenses is welcome. The mechanics of the proposals, however, raise some problems. It is reasonable to treat new employees, who may have to relocate to assume their duties, in the same fashion as transferred employees. However, in attempting to achieve uniformity in the tax treatment of reimbursed and non-reimbursed employees, the proposal would have reimbursements included in gross income with an offsetting deduction for specified costs, subject to an over-all limit of $2,500 for the "indirect" expenses.

The dollar limitation would limit the revenue loss to $100 million a year. We question whether that is an appropriate criterion in this situation. The personal income tax is a tax on net income and a reimbursement of expenditures incurred as a result of the taxpayer's employment is not income in an economic sense if no enrichment has taken place. The taxpayer is merely restored to the same position financially that he would have occupied had the transfer not taken place. They are expenses that the employer has agreed to bear because of the move. As such, the reimbursement is an employer expense -- not employee income. Similarly, in the case of new or non-reimbursed employees, the expense of the move should properly be considered as an expense attributable to the earning of income. We are not basically dealing with a revenue problem here, but with a technical defect in the law.

We would also like to point out that inasmuch as the categories of deductible expenses would be stringently limited, it is not necessary to provide additional controls in the form of dollar limitations.

One improvement that we suggest, if categories of deductible expenses are to be specified, is in the proposed time limit for deductible living expenses while occupying temporary quarters in the new location. The legislation now before your Committee would limit such deductible expenses to those incurred during any period of thirty consecutive days. We regard this as unreasonably restrictive. Many moves, for example, are made on short notice. If it is considered necessary to impose some time limitation, it should be not less than ninety days.

Also, the provision to extend the twenty-mile test to fifty miles seems unreasonable. Under this, no deduction would be allowed unless the taxpayer's new principal place of work is at least fifty miles farther from his former residence than was his former principal place of work. In many congested metropolitan areas where most jobs are located, an additional thirty miles of commutation is a real hardship and forces a move of residence. We recommend that the present twenty-mile test be retained.

It is our belief that the most realistic and equitable approach to moving expenses is that all reimbursements and allowances for reasonable expenses and losses actually incurred should not be subject to tax and that such expenses or losses to the extent not reimbursed should be allowed as deductions. If it is necessary to limit the expenses and losses so treated to certain categories, then certainly no further limitation should be imposed.

VIII - TAXATION OF COOPERATIVES

It has long been NAM's policy that the discriminatory distribution of tax burdens between cooperative and non-cooperative enterprises should be eliminated. The deduction of patronage refunds from income before the calculation of corporate income tax leaves cooperative enterprises in a preferred position with respect to retained earnings. This results in an advantage over their tax-paying competitors and a loss to the Treasury.

Section 531 of H.R. 13270 builds on the reform begun in the Revenue Act of 1962 by raising from 20% to 50% the patronage allocations that must be paid out currently. However, this change would take ten years to accomplish. This section also adds the requirement that, to be treated as qualified, patronage allocations and per-unit retains must be paid out in fifteen years. While this, too, is a step in the right direction, the period of time is much too long. At a minimum, your Committee should consider shortening the pay-out period requirement from fifteen years to five years.

IX - POLLUTION CONTROL

Section 704 of the bill provides for a five year write-off of investments in air and water pollution control equipment. We believe that broad social benefits accrue through the air and water quality control efforts of industry, and that in most instances these efforts do not bring an economic return. We advocate that such investments should be accorded accelerated amortization up to and including the immediate write-off of the facility, at the option of the taxpayer, plus a liberal tax credit as is provided in numerous bills which have been introduced in this and previous sessions of the Congress. Therefore, while the provision in the pending bill is a step in the right direction, it is still not commensurate with what is needed to achieve the benefits and alleviate the burdens involved in obtaining better environmental quality throughout the nation.

In addition, the provision includes two undesirable provisions. The first is a requirement that certification of the equipment must be obtained not only from a state agency but also from a federal agency. This dual certification requirement, with attendance red tape, paper work and delay, will serve to weaken attainment of the objective of the provision. Because the Congress has declared a national policy that the states have primary responsibility in the pollution control field, we strongly urge that certification of the equipment should rest with the state agencies.

A second undesirable feature of this provision is that it would authorize the Secretaries of Interior and Health, Education and Welfare to promulgate minimum performance standards for such equipment. This, likewise, is contrary to the declared Congressional policy of placing primary responsibility upon the states. We believe it would be unwieldy and impractical to put the federal government into the business of establishing specifications for the manufacture of this type of equipment.

X - CORPORATE MERGERS

Section 412 of the bill would disallow a deduction for interest on certain bonds issued in connection with the acquisition of a corporation. The only comment we have on this section is to suggest that it not apply to those cases where there is evidence of serious negotiations or a binding commitment prior to May 27, 1969, the effective date of the proposed section of the legislation.

XI - TRANSFERS OF FRANCHISES

Under Section 516(c) of H.R. 13270, amounts received upon transfer of a franchise would not be treated as proceeds from sale or exchange of a capital asset or of property to which Section 1231 applies if the transferor retains any significant power, right or continuing interest with respect to the subject matter of the

franchise. Such provisions, however, would not apply with respect to amounts received in connection with a transfer of a franchise to the extent attributable to the transfer of all substantial rights to a patent, trademark, or tradename, (or an undivided interest therein which includes a part of all such rights), to the extent such amounts are separately identified and are reasonable in amount.

In addition to patents, trademarks and tradenames, the transfer of a franchise could also include the transfer of other property necessary and pertinent to full realization of the benefits of the franchise, such as secret processes which have not been patented. We see no reason why property rights transferred in connection with a franchise which are not patented should be treated in a different manner than property in the form of patents. We recommend, therefore, that the exception contained in subsection (c) of proposed Section 1252 as now worded be amended to include "secret processes" in addition to patents, trademarks and tradenames.

XII - TREBLE DAMAGES IN ANTI-TRUST ACTIONS

I would like at this time to state the position of the NAM regarding a tax proposal which although not part of the House bill is now pending before this Committee. The proposal referred to, as contained in S. 2156 and S. 2631, would overturn a 1964 ruling of the Internal Revenue Service (Rev. Rul. 64-224) holding that amounts paid in satisfaction of treble damage claims under Section 4 of the Clayton Act are deductible for federal income tax purposes as ordinary and necessary business expenses.

We are opposed to the enactment of the proposal contained in S. 2156 and S. 2631 for the following reasons: (1) Rev. Rul. 64-224 is a correct interpretation of the applicable tax law; (2) the Tax Code should not be used for "backdoor" regulation of what is essentially a social and economic problem; and (3) the denial of a deduction for treble damages paid by a corporation harms the corporation's

shareholders who, especially in publicly-owned companies, will in general have been innocent of any wrongdoing.

The Supreme Court has consistently held that it will countenance the disallowance of otherwise permissible business deductions only where the allowance would "frustrate sharply defined national or state policies...". Commissioner v. Tellier, 383 U.S. 687 (1966). The Court has denied business deductions on the ground that they "frustrate sharply defined"public policies in only two categories of cases: (a) Payments of fines and penalties to governmental bodies, and (b) Payments specifically prohibited by longstanding Treasury regulations. Treble damages obviously do not fit the second category, and although there is contrary dictum in the case of Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), it has also been consistently held that treble damages are not meant to punish wrongdoers as is the case of fines and penalties, but instead are remedial and compensatory in nature. Huntington v. Attrill, 146 U.S. 657 (1892); Overnight Motor Transportation Co. Inc. v. Missel, 316 U.S. 572 (1942). Any legislation to deny a deduction for treble damages must be analyzed with the consideration in mind that it would be inconsistent with the principles laid down in the above line of cases.

It has been readily admitted by proponents of the subject proposal that it is intended as a deterrent to violations of the anti-trust laws. We submit that the Internal Revenue Code is the wrong place to deal with this problem. The anti-trust statutes already contain many deterrents to violations, including substantial fines and penalties which, even under present law, are not deductible. The integrity of the tax statute, however, should, we fee., be maintained. As stated by Mr. Justice Stewart in the Court's opinion in the unanimous decision in Tellier, supra:

> We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning.

The burden of a treble damage payment made by a corporation is ultimately, of course, borne by the corporation's shareholders. The subject proposal would increase this burden by denying the corporation a deduction for a payment which most agree is an ordinary and necessary expense of the corporation. This "sanction against wrongdoing" will thus harm persons who by and large, especially in publicly-owned corporations, will have been innocent of any wrongdoing.

For these reasons we urge that the proposal to deny a deduction for treble damage payments in anti-trust cases be rejected.

* * * * *

CONCLUSION

In conclusion, I would like to quote from an address by George Champion, former Chairman of the Board of The Chase Manhattan Bank, before our Taxation Committee last year. His remarks go right to the heart of the problem with H.R. 13270:

> For far too many people, the words still conjures up a 19th century vision of little old ladies clipping coupons in bank vaults. They think of capital as stagnant, lifeless having nothing whatever to do with them or the world they live in.
>
> These people must be reminded that capital is what keeps us all going, rich or poor, young or old. The American worker enjoys the highest standard of living in the world because somebody has invested $15,000 to $20,000 in the tools he works with. He is able to do the job because we are investing 6 percent of our total Gross National Product every year to educate him and millions of others. If he has time to think, to read, to dream, to enjoy life, it is because he is prosperous -- and he is prosperous because capital has been invested in him.

Capital is what keeps us going, and I urge your Committee to revise the anti-capital formation features of this bill so that it can continue to perform the job we all want it to.

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

Statement
on
H.R. 13270
THE TAX REFORM ACT OF 1969
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
WALKER WINTER

October 3, 1969

The Nation's largest business organization representing local and state chambers of commerce, trade and professional associations, and business firms.

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In brief, <u>the National Chamber supports</u>:

-- increasing the standard deduction as providing a degree of simplification for a large number of taxpayers;

-- reducing tax rates of individuals and corporations as providing a degree of equity for a large number of taxpayers;

-- adopting the 50% maximum tax rate on earned income, but requests the concept be applied to all personal income;

-- broadening of the allowable moving expense deductions, but recommends a liberalizing of the dollar limitations;

-- repealing of the unlimited charitable deduction;

-- enacting the Clay-Brown provision extending the unrelated business income tax;

-- liberalizing and simplifying of the income averaging provisions as granting needed relief from the overprogressive income tax rates, and

-- liberalizing depreciation provisions.

<u>The Chamber opposes</u>:

-- extending the capital gains holding period or changing the rate as seriously impairing the flow of needed investment capital;

-- limiting the use of accelerated depreciation on real estate as being harmful to an industry vital to our economy;

-- allowing an option to state and municipal governments to issue either taxable or tax-exempt bonds as a first step toward dependence on Federal subsidies;

-- changing the present law on deferred compensation, restricted stock, and lump-sum distributions

-- taxing revenues of exempt organizations unless derived from an unrelated business;

-- creating an excess deductions account as too complicated an approach to the problem of farm losses, and

-- the provision relating to the disallowance of allocated deductions.

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STATEMENT
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My name is Walker Winter. I am a Vice President of the Chamber of Commerce of the United States and Chairman of its Taxation Committee. I am also a partner in the Chicago law firm of Ross, Hardies, O'Keefe, Babcock, McDugald and Parsons.

I am accompanied by Robert R. Statham, Taxation and Finance Manager of the Chamber.

Mr. Chairman, the National Chamber appreciates this opportunity to present its views on the proposed Tax Reform Act of 1969. The American business community is exceedingly concerned with the burden of taxation and its effect on the economy. We commend your Committee for this intensive reappraisal of the taxing system. There should be a continuing and thorough consideration of the entire Federal tax system, with particular emphasis on the rate structure, other revenue sources, and on amendments needed to remove the ambiguities and the unintended hardships and inequities from the Code.

This legislation is said to be the most extensive attempt at reforming the tax laws ever undertaken. Assuming its passage, it will play a major role in the course of the Nation's economy, and every segment of the American free enterprise system is certain to be affected by its provisions. It is in the best interests of the country that this legislation be used to provide greater equity in the tax laws and simplify compliance for the taxpayer. It should not be used as an instrument to quash individual initiative to save and invest and provide jobs and a better standard of living for our citizens.

This legislation received hasty consideration in the House at the time of its passage. Legislation of this magnitude and complexity requires that a great amount of time be given to the review of its contents and impact on taxpayers. It is urged that the Committee give adequate time to the consideration

of the tax proposals in this bill. The goal is not the enactment of just a tax reform bill -- but the enactment of a tax reform bill to serve the long-term best interests of the Nation, and the Chamber urges the enactment of such tax reform legislation.

A reason given for the enactment of this legislation is to maintain the confidence of taxpayers in our self-assessment system of taxation. It is contended that taxpayer morale is an important factor to be considered. Serious questions have been raised these past months which tend to undermine the confidence of taxpayers, both individual and corporate, in the Federal tax laws. If this confidence is not restored, those administering the tax laws will have problems obtaining the revenue required for necessary government operations.

Many of the proposals in this legislation affect sections of the Code which have been on the books for many years and were adopted by the Congress with good and proper reason at the time. It is important that we guard against constant change in the tax laws lest this in itself have a demoralizing effect. It is realized that time and conditions change, and what may have been equitable in the judgment of Congress at one time may not now be considered equitable. Nevertheless, Congress must avoid including provisions in the tax laws which will require abrupt change after a short period of time. It is exceedingly important that adequate consideration be given to proposed changes to make sure that what is being enacted will provide lasting solutions rather than temporary confusion.

Summary of Chamber's Position

In brief, the National Chamber supports:

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-- adopting the 50% maximum tax rate on earned income, but requests the concept be applied to all personal income;

-- broadening the allowable moving expense deductions, but recommends a liberalizing of the dollar limitations;

-- repealing the unlimited charitable deduction;

.. enacting the Clay-Brown provision extending the unrelated business income tax;

.. liberalizing and simplifying the income averaging provisions as granting needed relief from the overprogressive income tax rates, and

.. liberalizing depreciation provisions.

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.. changing the present law on deferred compensation, restricted stock, and lump-sum distributions;

.. taxing revenues of exempt organizations unless derived from an unrelated business;

.. creating an excess deductions account as too complicated an approach to the problem of farm losses, and

.. the provision relating to the disallowance of allocated deductions.

Importance of Rate Reform

Under the provisions of H.R. 13270, during 1971 and 1972 tax rates of individuals will be reduced. When totally effective in 1972, the rate schedule will run from 13% to 65% instead of the present 14% to 70% range. The National Chamber favors tax rate reductions for both individuals and corporations and urges such reductions.

The National Chamber has consistently opposed the highly progressive income tax rates and the detrimental effect such rates have on our economy. Taxes should accomplish their purpose of raising revenues with the least harm to a free economy. Whenever tax rates get so high that they deter individual initiative from concentrating on improving business efficiency, they tend to divert that initiative into finding ways of avoiding taxes.

The 50-percent limit on tax rates applicable to earned income provided in the bill is a step in the right direction. However, it is the view of the National Chamber that the goal should be to get the maximum tax rate on all personal income below 50 percent.

With lower rates, the need for tax planning will be reduced and some of this Nation's most creative energies will be unleashed to contend with the myriad problems which confront us every day. We must attempt to confine our tax system to its prime purpose of obtaining essential government revenues without seriously injuring taxpayers and impeding economic growth. If we do not, we will have a revenue system which will be used as a means of forcing social and economic changes which are in vogue at that time. The result will ultimately be a more complex and incomprehensible code than we presently have, and the concept of equity among taxpayers will be subjugated to the pressing demands of the day.

Corporate Rate Reduction

This legislation provides for tax rate reductions for individuals but does not presently provide a rate reduction for corporations. The bill in its present form is out of balance. To provide tax rate reduction for one class of taxpayers and not for another, in effect, shifts the burden of taxation. Corporations under the provisions of this bill will not only be denied tax reduction but will get a tax increase as a result of the repeal of the investment tax credit. The original enactment of the credit was a reason given for not providing corporations the same tax reduction as individuals in the Revenue Act of 1964. The House Committee Report #749 of September 13, 1963, at page 27, stated:

> "This tax cut for corporations, when fully effective, will amount to $2.2 billion a year. It should, of course, be viewed in connection with the reduction provided by Congress last year in the form of an investment credit and the reform provided last year in the depreciation guidelines. These taken, together, provide corporations with a tax reduction of approximately $4½ billion."

And this Committee in its Report #830 of January 28, 1964, at page 8, stated:

> "This bill provides a balanced reduction between individuals and business firms. In this respect, the bill is much the same as the bill that came from the House. When fully effective, the bill will reduce individual income taxes by $9.2 billion and will reduce corporate taxes by about $2.4 billion. These figures must be

> evaluated along with the effective tax reduction of 1962 through the investment credit and depreciation reform, the largest share of which went to corporations. Taking the 1962 and 1964 programs together, the share of the reduction going to individuals is about two-thirds and to corporations about one-third, which is approximately the present relative shares of individuals and corporations in income tax liabilities."

Thus, to eliminate the investment tax credit results in a discriminatory increase in taxes for corporations. To give a tax reduction to individuals and not to corporations in this legislation compounds this discrimination. There is no reason why the taxpayer who has chosen to incorporate his business should be discriminated against, and the noncorporate taxpayer favored in legislation designed to provide tax rate reduction.

Simplification

Efforts should be made to simplify the tax laws. In terms of equity, the complexity of the Internal Revenue Code may be the largest loophole in the tax laws. This reverse loophole prevents taxpayers from utilizing provisions beneficial to them and is just as inequitable as the more renowned loophole which provides an unintended benefit. It might well be the information gap that exists between taxpayers on the one hand, and the reasons for the various sections on the other, that is playing a large role in generating the so-called taxpayers' revolt.

We realize simplicity and equity do not always go hand in hand, and that there must be complex provisions in the tax laws to provide fair treatment for many of our modern complex problems. While taxpayers bemoan the many pages added to the Internal Revenue Code each time Congress enacts a tax bill, there is simply no way in which this can be avoided entirely if we are to continue to place the emphasis which we now place upon the income tax as a source for raising necessary revenues. It is hoped, however, that simplification will be an ingredient of consideration for tax reform deliberations.

Standard Deduction

The National Chamber supports an increase in the regular standard deduction as the clearest way to simplify compliance with the tax laws for a large number of taxpayers. The resulting deduction should conform to the

deduction profile reflected in current returns in order to retain equity between taxpayers using the standard deduction and those itemizing deductions.

The bill increases the present 10% standard deduction with its maximum of $1,000 to a rate of 15% and $2,000 by 1972. Nearly 36 million returns will benefit from this increase. This is slightly more than one-half of all taxable returns. This will increase the number of taxpayers using the standard deduction from 58% to nearly 70%, resulting in a shift of 8.4 million taxpayers, who now itemize, to the use of the standard deduction.

Allowing 8.4 million taxpayers to eliminate the tedious bookkeeping necessary for itemizing deductions would simplify compliance and serve both the individual and government. It would greatly reduce the need for audits. Just as important, it would greatly simplify the tax laws for a large segment of taxpayers.

Income Averaging

Our sharply progressive tax rates are clearly one of the prime reasons for having income averaging provisions. Our rate structure results in significantly greater tax liability when an individual receives a large portion of his income in a single year, than there would be if that income had been received in equal amounts over several years. The income averaging provisions were designed to afford a measure of relief to such an individual.

The National Chamber supports the principle of income averaging. We believe that the benefit of the income averaging provisions is greatly increased by the provisions in the House bill. The Chamber urged in the House hearings that the 133 1/3 percent requirement be lowered to 120 percent or less and that the provisions be simplified. The House bill accomplishes this and also simplifies the provisions by not excluding capital gains, wagering and gifts from averaging.

The present income averaging provisions do not apply where the income of the current year is below the average base period income. The National Chamber recommends that averaging be available to those who suffer a reduction in income, on the same basis as those who have an increased in income. This form of averaging could be adopted by allowing a credit against current tax liability for a portion of prior taxes paid.

Moving Expenses

The National Chamber believes that employee moving expense deductions are in the best interest of the Nation and the economy, and will not result in the loss of tax revenue over the long run. A mobile labor force is a necessity. Factors which restrict mobility and cause employee hardship should be eliminated. Many companies have realized this and are reimbursing their employees for moving costs. These reimbursements are not considered compensation by employers or by the employees. This is merely an effort to reduce the personal loss caused by an employee's move from one job location to another.

The provisions of H.R. 13270 reduce the inequities of employee moving expense taxation by allowing deductions for the following:

1. Expenses for premove househunting trips, including cost of transportation, meals, and lodging for the taxpayer and members of his household;

2. Temporary living expenses at the new job location, including costs of meals and lodging for the taxpayer and members of his household at the new job location while waiting to move into permanent quarters, and

3. Certain expenses of selling the old house, buying a new house, or settling an unexpired lease.

Allowing these deductions will lessen the tax burden on employees who are reimbursed for financial losses incurred in moving from one job location to another. These deductions would be allowed whether or not taxpayers are reimbursed by their employers.

In conjunction with the above proposal to broaden the allowance for moving expense deductions, the bill provides for a $2,500 overall limitation on these three new deduction categories. The total of the first two cannot exceed $1,000. The National Chamber does not feel that such limitations are appropriate. If the categories of allowable expenses are reasonable, then the actual expenses incurred should be allowable without regard to an arbitrary limit.

Under the terms of the bill, the so-called 20-mile test would be increased. Presently, to qualify for moving expense deductions, the taxpayer's new place of employment must be at least 20 miles farther from his old residence

than his old place of employment. The 20 miles has been changed to 50 miles. This proposal is inequitable and would result in unfair treatment. According to the House report this was done to eliminate deductions for inter-suburb moves within a metropolitan area. However, to illustrate the inequity of such a proposal, a 50-mile limit could eliminate the deduction for a taxpayer who had a job change from Washington to Baltimore.

It is important to consider that a number of companies are moving out of the cities and into the suburbs. A 50-mile test would be restrictive on many of the lower income employees who live in the city, and discourage them from following their employment. Clearly this is a change which should be given further consideration before being adopted.

The National Chamber has long supported a broadening of the moving expense deduction. The Chamber would go further and include expenses of improving the salability of the old residence and also include any miscellaneous expenses related to the move.

Capital Gains

This legislation is prone to place a much greater tax burden on the investor. This is particularly true in the case of capital gains. The economic consequences of the proposals in this area are certain to be undesirable not only for those taxpayers affected, but also for the Nation as a whole. The Administration recognizes this. In his testimony before this Committee on September 4, 1969, Secretary of the Treasury David M. Kennedy stated:

> "Investment in the years ahead may also be impeded by the proposed changes in tax treatment of capital gains. We believe these changes go too far. Our original proposals were designed to prevent excesses rather than fundamentally alter such tax treatment. Accordingly, we recommend retention of the 6-month holding period, as contrasted with the extension to one year in H.R. 13270. In addition, we favor retention of the maximum 25 percent rate on capital gains, except in cases of very large gains relative to ordinary income. In these instances, which would affect a relatively small number of individuals, the rate could rise as high as 32-1/2 percent, or to half the new top bracket rate of 65 percent."

Lengthening the capital gains holding period from six to twelve months is not in the national interest. Such a change in the tax laws is certain to

reduce the availability of venture capital and inhibit economic growth. Investors who are now willing to place their savings in high risk ventures are going to be more reluctant to make such investments. We do not agree with the House Committee report that the 6-month holding period does not properly carry out the intent of Congress to provide special tax treatment for investment as distinguished from speculative gains. The 6-month period is ample to eliminate both those who make a living from short-term sales and those engaged in highly speculative short-term ventures. It may be true there is a bunching of transactions at the end of six months, but this is to be expected from any length of holding period provided in the law.

It is important that the tax laws not discourage the free flow of capital from one investment to another. Extending the holding period would have the effect of doing just that. Investors would find their capital frozen into investments, and would be deterred from switching to better investment opportunities during the extended holding period. Instead of placing less emphasis on the tax consequences of business transactions, anyone making an investment would have to be fully aware of the tax results of such a lengthy holding period.

Tampering with the holding period could have serious long-term effects on the industrial and technological growth of the country. The financing of new plants and equipment is in large measure dependent on funds provided from the issuance of corporate securities. The effect of this provision would be to discourage investment in such securities and to increase financing costs.

The repeal of the alternative rate for individuals also produces similar problems. While it is true that this primarily affects a relatively small number of taxpayers in the higher income brackets, it is this group that provides much of the risk capital. Again we see an instance in which the tax laws could have the effect of freezing investment capital. The National Chamber also opposes increasing the alternative capital gains tax rate for corporations.

State and Municipal Bond Interest

The interest on state and local government securities has been exempt from Federal income tax since the tax was adopted in 1913. The exemption does not apply to certain industrial development bonds which were made taxable as a result of the Revenue Expenditure Control Act of 1968. In almost all tax reform

hearings since the adoption of the income tax, elimination of the exemption of interest on state and local government securities has been discussed, but Congress has chosen to retain it.

State and local governments are highly dependent on bond issues to finance schools, colleges, hospitals, highways and other capital improvements. Any abridgment of this bonding power can result in a greater load being placed on the already overburdened property tax. In addition, many state legislatures are already finding difficulties in locating new sources of revenues to meet increasing costs of state and local government. Neither the states nor the local governments can afford to be saddled with needless additional costs of government.

It is the view of the National Chamber that any change from the present tax treatment of interest on state and municipal securities would not be in the best interests of the Nation and of maintaining the independence of the states and municipalities. Granting states and municipalities the option of issuing taxable bonds and having the Federal government pay the additional interest costs involved by subsidies to the states and municipalities is another step toward greater Federal domination.

Under the proposals in this legislation, the choice of issuing taxable or tax-exempt bonds appears to be left to the state or municipality. However, where a premium is offered to those issuing taxable bonds, it seems that the practicalities are diluted. If most of the new bonds are issued as taxable by "choice", then it will only be a short time before it is concluded that the tax-exempt choice is no longer needed. A new avenue is then opened for more intervention by the Federal government in the affairs of state and local governments. It offers the opportunity for strings to be placed on the subsidies.

The long-run effect of this legislation is to remove the tax-exempt status of state and municipal securities and to make the states and municipalities more dependent on the government in Washington. This provision should be removed from the legislation.

Real Estate Depreciation

The need for housing in the decade ahead presents an acute problem With the construction industry playing such a vital role in the economy and

in the solution of so many of our social problems, it is difficult to rationalize the restrictions being proposed on accelerated depreciation at this time.

Under the bill the 200-percent declining balance and the sum of the years digits methods of real estate depreciation are limited to new residential housing. Other new real estate is to be limited to the 150-percent declining balance method. For used buildings acquired after July 25, 1969, only straight-line depreciation is to be allowed. These provisions are sure to have a devastating effect on the construction industry.

Accelerated depreciation for real estate is often referred to as a tax shelter, and those who use it often are referred to as speculators. Those who make such references often fail to point out how many people are living in new housing because these provisions are in the tax law. They fail to point out how many blighted areas have been changed with the construction of new buildings by those who used these tax provisions. They fail to point out how much new construction has been added to the property tax rolls to share the cost burden of local government.

The House report suggests the prime reason for the changes in this area is to prevent tax avoidance. Certainly the tightening of the recapture provisions of Section 1250 is the better method of attacking this problem. Such an approach will not have the effect of discouraging investment that some of the proposed changes in the law in this bill will have.

Employee Compensation

The National Chamber opposes the proposed changes in the current tax treatment of non-qualified deferred compensation plans. Deferred compensation has been used by both large and small companies for a number of years to attract executive talent. This bill would have the effect of discouraging the use of certain types of executive compensation. It would tax deferred compensation at rates applicable to compensation when earned, rather than at rates applicable at the time the compensation is received.

In effect, deferred compensation is a promise by the company to pay a sum of money in the future, under circumstances where there is not constructive receipt. Certainly to tax this income as though it were received is not in keeping with the concept of taxation of income on a cash basis.

Subjecting deferred compensation to a minimum tax on deferred payments over $10,000 in a year will add greater complexity to the Code. While such complexity may be necessary for the sake of equity, it appears that this provision is certain to require very complicated computations for a number of taxpayers.

The bill does not consider deferred compensation as earned income for purposes of the 50% maximum marginal tax. As a result, future deferred compensation payments that are thrown back to 1970 and thereafter, can be subjected to a tax in excess of 50%, but the same income under the terms of the bill would have a maximum rate of 50% if it were not deferred. This difference in treatment accorded earned income and nonearned income does not appear to be equitable.

The National Chamber is opposed to provisions in the bill which would eliminate the present capital gains treatment accorded lump-sum distributions from qualified employee plans. These changes could have the effect of almost doubling the employee's tax on employer contributions by taxing those contributions at ordinary rather than capital gains rates. This would result in employees having less money available at the termination of employment than they had anticipated. Most of those who would be hurt by what is being proposed are employees with modest incomes. Many of them have built their plans for retirement around profit-sharing plans. The increased tax burden would have depressing effects on their future economic welfare. The burden is not eliminated by the averaging formula proposed.

This proposal to eliminate the capital gains treatment of lump-sum distributions is also certain to have an impact on Federal revenues. The incentives for greater productivity of the employee who participates in a profit-sharing plan will be diminished by the greater tax burden inflicted by this legislation. This reduced economic productivity is certain to have the effect of reducing Federal revenues.

The provisions of H.R. 13270 would tax receipt of restricted stock when the risk of forfeiture is removed. Thus, taxpayers could be taxed immediately on property which they might not be able to sell to pay the tax. This presents the serious problem of requiring taxpayer liquidity upon receipt of a nonliquid asset.

The Chamber recommends two limitations to the current restricted stock provisions which would eliminate abuse in this area without destroying their basic usefulness. First, the stock used should be limited to company stock or stock of an affiliated group. This assures that the employee's future is directly tied to his employer's. Second, the issuance of the stock must be tied to employment. In this way it cannot be used for payment to independent contractors.

It is most important to encourage employee stock ownership. This is best achieved through the use of stock options and restricted stock plans. Key employees must be retained by a company and tend to increase the productivity of that company. Increased productivity is an important factor in fighting inflation, and any disruption of a company's employee compensation practices may reduce that company's output.

Limit on Tax Preferences and Allocation of Deductions

With regard to the provisions in the legislation relating to the limit on tax preferences, the National Chamber recognizes the problem that exists and that some individuals can avoid paying taxes. But the Chamber does not endorse the LTP. This change in the tax laws is exceedingly complex. It places an emphasis on gross income, and could very well become the forerunner of a gross receipts tax on all taxpayers. New taxes often are designed to affect only a few individuals, but as the need for revenues increase the temptation is to enlarge their scope to include everyone.

Other sections of the bill directly affect the same so-called preference areas included in LTP. This direct treatment is the preferred approach if changes are to be made.

The Chamber opposes the provision relating to the disallowance of allocated deductions in H.R. 13270. Again the complexity and administrative problems associated with this proposal are enough to cause second thoughts about its wisdom. If this provision is enacted few, if any, investment decisions will be made by individuals without the guidance of an expert tax advisor. The purpose of this provision is to tax income indirectly which is not taxed directly. Many of the tax problems in existence today are due to attempts to do indirectly what would better be done directly.

Unlimited Charitable Contributions

The National Chamber supports the elimination of the unlimited charitable contribution.

Depletion and Mineral Production Payments

The National Chamber believes that the attainment and maintenance of a sound domestic mining industry requires more ample recognition in the tax laws that mining is unique. It is unique in that it exhausts its assets in the course of its operation; that exploration for and discovery and development of new mining deposits continually grow more difficult, more costly and financially more hazardous; and that a recovery of capital and return on investment commensurate with the risks is essential to induce venture capital to enter this hazardous financial field.

To meet the required national needs and to assure adequate continuance of the industry by the replacement of exhausted mineral assets, the tax laws should provide that all nonrenewable natural resource industries be granted adequate depletion allowances. In addition, provision should be made for the current deduction of research prospecting, exploration and development costs or, at the election of the taxpayer, such deferment as the taxpayer deems most appropriate in each case, without the now-existing limitations.

Tax laws must recognize that rising energy demands in this Nation require the constant development and maintenance of a healthy petroleum industry. Exploration and development of petroleum resources grow more difficult, more costly, and financially more hazardous. Venture capital will continue to be attracted in this field only if the reward for success is commensurate with the risks involved. Therefore, to meet national needs and to assure development of oil and natural gas produced for energy use, the Chamber believes the tax laws must continue to provide adequate depletion allowances.

Gasoline Taxes

It has been recommended at these hearings that nonbusiness state gasoline taxes no longer be deductible. State gasoline taxes paid by an individual are presently deductible for Federal income tax purposes, even though they are not business expenses. The National Chamber believes that this is correct and that such deductions should be permitted so long as deductions are allowed generally for state taxes paid.

Deductibility of Antitrust Treble Damage Payments

Presently, amounts paid in satisfaction of treble damage antitrust claims under Section 4 of the Clayton Act are fully deductible as business expenses for Federal income tax purposes. There has been some discussion that changes might be made in the tax reform bill to prohibit deduction of two-thirds of such treble damage payments where the taxpayer has been convicted of violation of the antitrust laws or has entered a plea of guilty or nolo contendere in such litigation.

Where the purpose behind the statute compelling the wrongdoer to make payments is remedial in nature and is intended to provide a formula for the reparation of a private injury -- such payments properly constitute allowable deductions. Where a law is intended to punish a wrongdoer, punishment would be mitigated by the allowance of an income tax deduction. Actions that are brought under Section 4 of the Clayton Act are remedial in nature, since the purpose behind that section of the Act is to allow the victim a method of recovering the damages inflicted and not to punish the wrongdoer. To disallow the deduction of treble damages would amount to ignoring the remedial characteristic of that part of the law and inflict punishment by use of tax laws.

The tax laws should be used for the purpose of collection of revenues to meet the necessary costs of government. Their purpose should not be extended to inflicting punishment for violations of nontax laws.

The antitrust laws are very complex. It is often difficult for those in the agencies of government who enforce the laws to agree on whether a violation has occurred, and the courts have often experienced difficulty in determining whether the law was violated. This difficulty of interpretation means that there will be businesses subjected to treble damages even though they have made every effort to avoid violating the antitrust laws. In such cases, treble damages provide remedial relief for the injured party, and the tax laws should not inflict a fine in such cases.

Clay-Brown

As a result of the Supreme Court decision known as the Clay-Brown case, some tax-exempt organizations have become involved in certain business activities completely unrelated to their exempt purpose. Situations have occurred where a tax-exempt foundation acquires the stock of a corporation by agreeing to pay the

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former owners a percentage of the profits up to a specified total. The corporation is then liquidated and its assets leased to a new company for a rental somewhat less than the installment payment obligations of the foundation. The rental payments create deductions for the new company, thus reducing its tax liability, while the rental receipts are tax free to the recipient exempt organization. The former owners are subject only to capital gains taxation.

The National Chamber supported the original tax on unrelated business income of exempt organizations. It so testified in 1950, when this legislation was first before Congress. The Chamber supports the provisions in H.R. 13270, which would expand the unrelated business income tax to include the unrelated debt-financed income of exempt organizations where the organization obtains such income from property acquired or improved with borrowed funds.

Advertising Income of Exempt Organizations

The bill provides that advertising income of an exempt organization is unrelated business income even though carried on in connection with activities related to the organization's exempt purpose.

The National Chamber has consistently supported taxing unrelated businesses of tax-exempt organizations. However, the Chamber opposes taxing revenues of tax-exempt organizations unless derived from an unrelated business.

In 1950, Congress enacted the provisions to tax the unrelated business income of certain exempt organizations. The action was taken because some exempt organizations were engaging in businesses totally unrelated to their exempt purposes. Examples cited in Congressional hearings in 1950 included some colleges and other institutions engaging in a variety of business undertakings such as the production of automobile parts, chinaware, and food products, and the operation of theatres, oil wells and cotton gins. These businesses were totally unrelated to the exempt purposes of the organizations involved and were rightly made subject to tax. They did nothing to further the exempt purposes of the exempt organization other than to provide a source of funds. Thus, Congress enacted the tax, generally equivalent to the tax on corporations, to apply to the income derived by exempt organizations from an "unrelated trade or business".

After the enactment of the 1950 tax on unrelated business income of tax-exempt organizations, advertising income of tax-exempt organizations continued

to be exempt. Interpretation of the law by the Internal Revenue Service, by Treasury, by exempt organizations, and by taxpayers in general was that advertising income of such organizations was exempt by law. Then in 1967, seventeen years after the enactment of the unrelated business income tax, the Treasury Department decided that it would adopt new regulations and tax advertising income of exempt organizations. This interpretation of the law by the Treasury regulations was contrary to the legislative history of the 1950 statute and the intent of Congress in its enactment.

Although it was discussed at the hearings of the Internal Revenue Service, the question of competition is not the issue. The law makes no reference to competition, does not use it as a test, and as a matter of fact it would be impractical to do so. An unrelated business of a tax-exempt organization is taxable whether or not it is competing with anyone else. A related business is not taxable under the law -- whether or not it is competing.

Practically every tax-exempt organization competes in a business way. The monthly church dinner competes with the restaurants, the annual benefit show of the local boys' club competes with private theatres, the swimming pool of the local civic association competes with commercial swimming pools. No one suggests these activities should be taxed when they are an integral part of the exempt purpose of the tax-exempt organization -- they are related businesses. They may be separate businesses and they may compete -- but that is not the test.

The test is whether there is a business and whether it is related. Congress knew this in 1950, understood why this had to be the test, and this is what was enacted in the law.

The Code applies the unrelated business income tax only to the income from an "unrelated trade or business". If an exempt organization publishes a magazine containing advertising, the trade or business is obviously publishing the magazine. Selling advertising is merely one integral activity in the overall operation of publishing the magazine. What the regulations say is that even though publishing is a business and is related, and therefore exempt, advertising is a separate business and is taxable as an entity, and this is what the proposal in the bill would tax. This runs contrary to the general principles of taxation which treat a trade or business as the integrated sum of its various activities.

The Supreme Court of the United States has recognized that you cannot fractionate advertising from editorial content. In the case of Grosjean v. American Press Company, Inc., 297 U.S. 233, the Court recognized that taxing advertising is taxing the entire publication.

Practically all of the state and local chambers of commerce and trade and professional organizations affiliated with the Chamber of Commerce of the United States issue some type of regular publication. These publications explain to people in this country and around the world the workings of the free enterprise system, the American way of life, and our form of government and economy. These publications should not be discouraged. Certainly some of these publications include advertising -- it makes them attractive and assists in paying the cost of the publications. Everyone agrees the tax revenues to be obtained from taxing their advertising income is small.

The National Chamber has consistently fought for the principles of free enterprise. It will not refrain from fighting for the maintenance of the publications of its affiliated organizations which advance the cause of free enterprise.

A further problem exists with the fact that the new Code Section 513(c) proposed by Section 121(c) of the bill, is headed "Advertising, Etc., Activities". If the provisions of this Section are to be enacted, it is urged this heading be corrected so there will be no need to litigate the meaning of "Etc., Activities".

Farm Losses

The National Chamber is aware of the problems which arise from special farm provisions. This is true with respect to receiving capital gains on the sale of items whose cost was an ordinary deduction. However, the Chamber believes that the excess deductions account is too complex and should not be used as a method of solving the problem.

In addition, applying the excess deductions account provisions to only those individuals who have nonfarm income in excess of $50,000 discriminates against those farmers who are investing in other areas because farming may not be as profitable as it used to be.

Depreciation

It is unfortunate that this legislation does not contain needed depreciation reform. If the investment tax credit is to be repealed, then this legislation should provide the kind of permanent capital recovery tax system this country must have if its industry is to compete with the products of other industrial nations. The Treasury Department is making studies in this area. We urge that reform in this area be given priority. It is important that efforts be made to write permanent depreciation rates and allowances into the law, instead of requiring a dependence on the depreciation guidelines, which can be changed at any time by administrative action. We also urge that this Committee take action to eliminate by law the unfair and highly complex reserve ratio test.

Conclusion

On behalf of the National Chamber I wish to again thank you, Mr. Chairman, and the members of the Committee for this opportunity to testify on the wide range of provisions in H.R. 13270. Your Committee is to be commended for holding these hearings and demonstrating your concern for the vital problems of tax reform. We hope we have been helpful in presenting the views of the business community to the Committee.

STATEMENT OF

SAUL PEARL, PRESIDENT
MACHINERY DEALERS NATIONAL ASSOCIATION (MDNA)

BEFORE THE

COMMITTEE ON FINANCE, UNITED STATES SENATE
WASHINGTON, D.C.
OCTOBER 3, 1969

Mr. Chairman and Members of the Committee:

My name is Saul Pearl and I appear here today as a member of the small business community as well as in my capacity as President of the Machinery Dealers National Association (MDNA).

MDNA is a national trade association composed of 300 companies who have joined together to promote the growth of the used machine tool industry in the United States and Canada. The Association has asked me to testify primarily on the failure to include tax revisions in H.R. 13270 to assist small businesses. We believe that tax incentives should be provided for small businesses or in the alternative, H.R. 13270 should be amended to include reforms of the depreciation tax structure. This vital segment of the American economy is hampered more than ever by the shortage of working capital, compounded by the high interest rates and spiraling inflation.

We are concerned because our members and most of our customers are small businesses. The products of our industry, reconditioned used machine tools, often present the only economically justifiable means for the medium or small business enterprises to modernize their facilities.

Small businesses in the United States have a difficult time competing with large domestic and foreign firms because they have difficulty in securing adequate capital, both debt and equity. These problems are particularly acute in the metalworking industry where capital outlays are necessarily high. To illustrate, the Subcommittee on Special Investigations of Small Business Problems of the House Select Committee on Small Business held hearings in 1966 on the problems of the tool and die and the machine tool industries and reported to Congress that (1) these industries are basic to the economic health of the nation; (2) that it is essential for these industries to modernize and expand their productive capacities; (3) that additional financing is not available from the private sector of the economy or from special programs of the Small Business Administration. Due to inflated costs and high interest rates, conditions today are less favorable than in 1966.

In Secretary Kennedy's appearance before this Committee on September 4 and 5, he indicated that the Treasury Department was considering other tax incentives to replace the investment credit which would stimulate the continued modernization and expansion of our nation's industrial plants. When and if these incentives are considered by the Congress, we would hope that special attention is given to the problems of small businesses. In the interim, we hope that the Committee will amend H.R. 13270 to provide special relief for small businesses in the following particulars:

1. The investment credit should be reinstated, limited to the first $100,000 of purchases of both new and used equipment.

The prospect of the total repeal of the investment credit has already had its impact. Sales of machine tools, both new and used, are among the leading indicators used to gauge the domestic economy. We note that used machine tool sales in August 1969 declined 19% from July and plummeted 39% in the last 3 months. New machine tool sales in August declined 16% from July and now are 56% below levels 4 months ago. In our judgment the limited reinstatement of the investment credit would be the simplest and most effective means of preserving many of our nation's small businesses.

2. The noraml corporate tax rate should be reduced on the first $25,000 of taxable income from 22% to 20%. The 26% surtax would remain in effect, thereby making the total corporate rate 46%.

Secretary Kennedy recommended a reduction in the corporate rate to 46%. MDNA's recommendation concerning the normal and surtax rates is consistent with Secretary Kennedy's recommendation except that by reducing the normal rate, rather than the surtax rate, small businesses would more significantly benefit.

3. The depreciation tax structure should be reformed to provide faster write offs on purchases of new as well as mixed groups of new and used equipment.

Most of the major industrial nations permit industry a rapid write off of plant and equipment investments which provides a greater cash flow for research and development, and additional investments in new plants and equipment. The Depreciation Guidelines, issued by the Treasury Department in 1962, moved in the direction of the depreciation pattern of other nations, except for the reserve ratio test. Previous witnesses have presented testimony on the shortcomings of the reserve ratio test and I have no intention of taking up the Committee's time by repeating those criticisms. In brief, MDNA believes that it is essential to eliminate the reserve

ratio test not only because of its complexity but also to establish more effective depreciation patterns.

For the years 1950 through 1967, fixed investment as a percentage of gross national product was less in the United States than in any major developed country, except the United Kingdom. Unless more internal funds can be generated by American industry, and particularly by small businesses, we will find our competitive position weakening in the world marketplace. Internal cash flow could be generated by amending Section 167 of the Internal Revenue Code to eliminate the requirement that the taxpayer establish a salvage value for depreciation purposes. The need for a taxpayer to take salvage value into account is obviated by the depreciation recapture provisions of Section 1245. This section works automatically to recover as ordinary income any gain on the sale of equipment which is attributable to depreciation deductions. Accordingly, we recommend that Section 167 be amended to do away with the requirement that the taxpayer's annual deduction for depreciation should be limited by the salvage value.

Another way to provide direct assistance to small business would be to increase the additional first year depreciation allowance of Section 179 from the

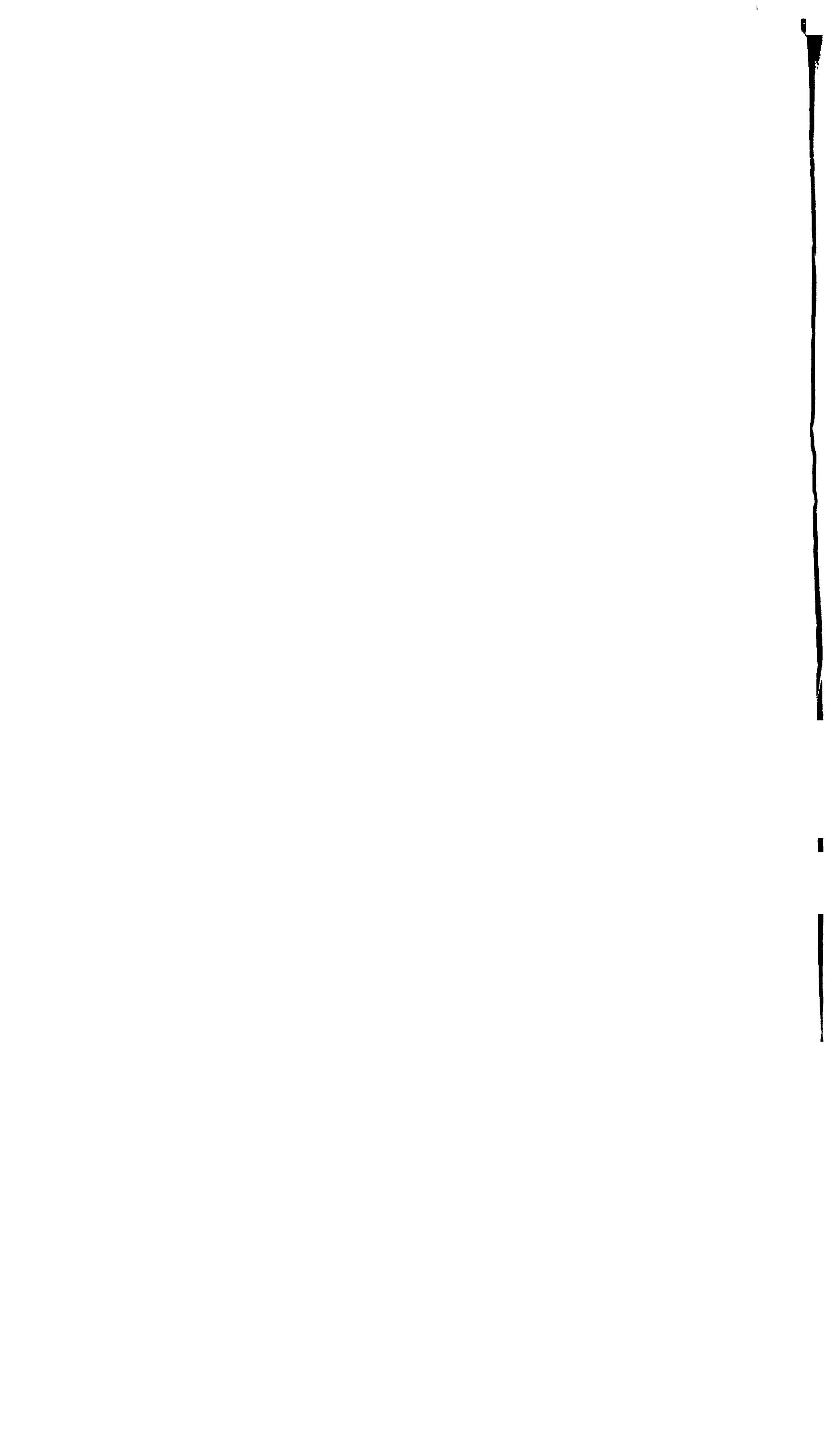
present $10,000 ceiling to a more realistic level of at least $25,000. The existing $10,000 ceiling has remained unchanged since this section was added to the Code in 1958. During that period, costs have spiraled to such an extent that the $10,000 ceiling is no longer realistic.

Purchases of modern used machinery enables many small firms to upgrade and modernize existing facilities. Depreciation incentives applicable to both new and used machinery will not encourage prospective purchasers of new machine tools to purchase used machinery since these items do not compete in the same market. The average cost of a new domestic machine tool is nearly $22,000, while the average price for a used machine tool is approximately $4,500.

In summary, MDNA recommends that Congress provide specific incentives for small business to modernize existing plant and equipment or, in the alternative, to reform the existing depreciation structure by eliminating the reserve ratio test, removing the salvage value as a consideration in determining allowable depreciation, increasing the $10,000 ceiling on the additional first year depreciation to $25,000 and by permitting rapid write offs for equipment. This latter recommendation should take into consideration the shorter remaining useful life of used equipment.

We appreciate this opportunity to appear before this Committee and will do our best to answer any questions which members of the Committee may have.

Machinery Dealers National Association
1400 Twentieth Street, NW
Washington, D. C.



SUMMARY

of

Statement to Senate Finance Committee

on Tax Reform Bill (H.R. 13270)

by

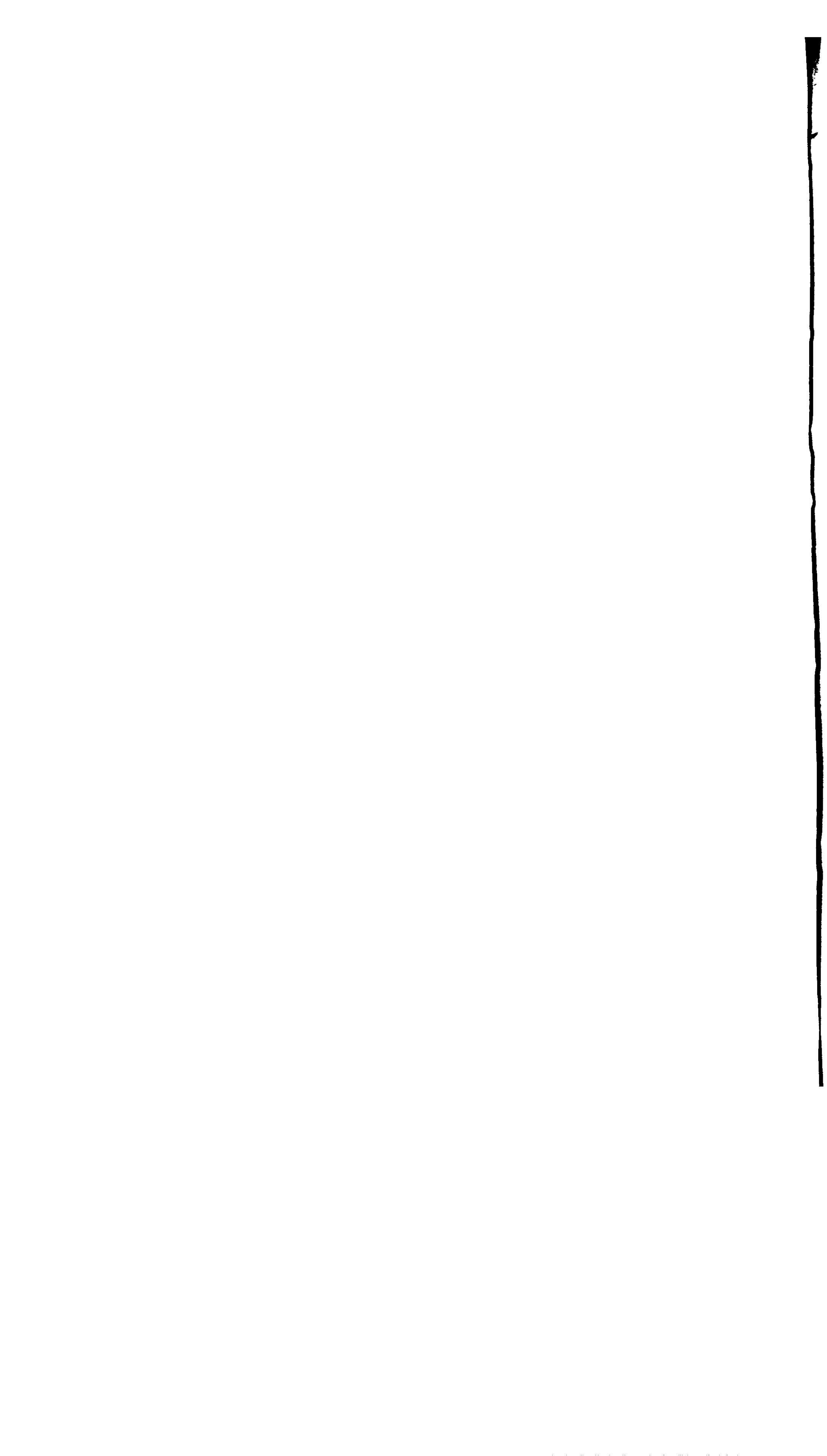
Harold Ketelhut
UAW Member
Freeport, Illinois

October 3, 1969

I am a member of Local 766, United Auto Workers International Union. I have been a continuous union member since 1941, and from 1953 through 1958 served as a Local Business Representative for the International Association of Machinists on a full-time basis.

In my opinion, the political activities of <u>all</u> tax-exempt organizations should be curbed -- including the political activities of tax-exempt labor unions. I resent the fact that the UAW has used my dues money in efforts to defeat political candidates I support. Last year it opposed the re-election of the late Senator Dirksen, who was a member of your Committee.

To me, "tax justice" means that all individuals and organizations would be treated justly and equally by the government. Preserving tax loopholes for unions that spend their members' dues for political action would be a great injustice to the working people of this country. That's my opinion and the opinion of almost every worker I've ever met.



Statement to Senate Finance Committee

on Tax Reform Bill (H. R. 13270)

by

Harold Ketelhut
UAW Member
Freeport, Illinois

October 3, 1969

Mr. Chairman and Members of the Finance Committee:

My name is Harold Ketelhut, and my home address is 915 South Chippewa Avenue, Freeport, Illinois. I am employed by Twin Disc, Incorporated, of Rockford, Illinois, and I am a member of Local 765, United Auto Workers International Union. I have been a continuous union member since 1941, and from 1953 through 1958 served as a Local Business Representative for the International Association of Machinists on a full-time basis.

In 1958 I helped organize the employees of a company in Monroe, Wisconsin Contract negotiations with the employer began after the IAM was certified as the legal bargaining representative of the employees. The international union sent one of its representatives to Monroe to assist the new local's union's bargaining committee -- or so we thought.

In the absence of members of the local bargaining committee, this International Representative offered management a deal. He said, in effect; "If you'll agree to include a 'union shop' clause in the contract so we can collect dues from the employees, I'll permit you to set the wage rates." The company's spokesmen accepted this offer. As a result, all employees were compelled to pay dues

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to the local union, and the local bargaining committee had no voice in determining the wage rates. I have good reasons for believing that some union officials are more concerned about collecting dues than about getting higher wages for the employees they are supposed to represent.

I won't pretend that I have read, or that I understand, every section of this 368-page tax bill. But I have read Section 101(b), which proposes taxation of tax-exempt private foundations which engage in political activities As I understand it, and the language seems quite clear to me, a 100% tax would be levied on any amount of money spent by a foundation for political purposes. For example, that tax would be applied to a sum of money used by a foundation to sponsor a voter registration drive.

In my opinion, the political activities of all tax-exempt organizations should be curbed -- including the political activities of tax-exempt labor unions.

In order to earn my livelihood as an employee of Twin Disc, Incorporated, I am paying union dues against my will. I resent the fact that the UAW has used my dues money in efforts to defeat political candidates I support. Last year it opposed the re-election of the late Senator Dirksen, who was a member of your Committee.

A few years ago Senator Dirksen wrote an article which was published in the DePaul University Law Review. I quote the following from his article:

"It is well known to everyone that American unions have for the past many years been highly active in politics. . . Large armies of union staff personnel are assigned to work in political campaigns at the precinct level in getting out

the vote for union-endorsed candidates; union newspapers and other publications are heavily devoted to promoting favored candidates, and union funds derived from membership dues and fees are liberally distributed to such candidates."

And then Senator Dirksen asked a question which applies to me and millions of other wage-earners:

"Where does this leave the individual worker who is required under a compulsory unionism agreement to pay his dues and fees into the union as a necessary condition to holding his job?"

I am one of many UAW members who have been vocal in objecting to partisan politicking by officials of our union. We're not paying these union officials to tell us we should vote for certain candidates for public offices; we're paying them to serve as our collective bargaining agents.

The uproar from rank-and-file members became so loud that the union hierarchy felt something should be done during the international union's last convention to pacify us. With the strong backing of the international's officers, delegates to the convention voted to amend the UAW constitution. In theory, at least, the new amendment permits a member who objects to the union's political program to designate a portion of his dues for a charitable institution of his choice.

By urging this action, UAW officials admitted they have been using some of the dues money for political purposes. Last March I wrote the first of several letters to an official of my local union and to the international union's secretary-treasurer. I requested that the portion of my dues which was used for political purposes be allocated to a crusade on behalf of handicapped children.

I finally received a letter early this month from the crusade director thanking me for a $75.00 pledge. Obviously, the union does not intend to refund the money which was taken from me in the past and used in support of political candidates and causes I and many other union members oppose. I suppose the union will ear mark a portion of my future dues for the handicapped children's crusade, but I don't know whether the $75.00 pledge will be fulfilled during the next 12 months or during the next five years. The union officials I've written to haven't bothered to let me know.

According to the union newspapers I receive, this tax bill is the greatest thing to come down the pike since the Wagner Act. Walter Reuther and George Meany disagree on many subjects, but they apparently agree this is the kind of tax reform the country needs. Well, they're not speaking for me on this issue.

To me, "tax justice" means that all individuals and organizations would be treated justly and equally by the government. Preserving tax loopholes for unions that spend their members' compulsory dues for political action would be a great injustice to the working people of this country. That's my opinion and the opinion of almost every worker I've ever met.

I understand that the bill before you proposes to tax the income received by churches from investments in unrelated businesses. I know that at one time the International Association of Machinists was one of the bigger stockholders in Sears, Roebuck and Company. I know the IAM owns a sizable office building here in Washington. I don't know whether the unrelated business income of unions is

now taxed. But if it isn't, it should be -- especially if Congress decides to impose a tax on the unrelated business income of the churches.

In my opinion, it's unfair to deny a tax exemption to one organization on the basis of its political activities and wink at the political activities of another tax-exempt organization. What's sauce for the goose is still sauce for the gander. I earnestly hope you will vote to deny tax exemptions to all organizations which use any part of their income for any kind of political activity. This would serve to discourage the misuse of money earned by workers to support the political whims of union officials.

I thank you for your attention and the valuable time you have allocated to me.

Principal Points in Statement of

Mrs. J. M. Ford
ILU Member
Lawrence, Kansas

to the

SENATE FINANCE COMMITTEE

on H. R. 13270

October 3, 1969

I object to the failure of the House bill to propose a tax on the unrelated income of labor unions.

I also object to the favored treatment unions receive with regard to political activities. The bill will impose a severe tax on tax-exempt foundations if any of their money is used for any kind of political program -- including voter registration campaigns. But I can't find anything in this bill which says labor unions will also be taxed if they spend money for voter registration drives or other political activities.

Recently I read in the newspapers that the national AFL-CIO president appeared before this Committee to speak for what he called "tax justice." I can't see any justice in compelling workers like me to pay dues to a tax-exempt union that spends our money to elect political candidates we workers are against.

Earlier this year our state legislature passed a bill favored by every worker I know. But the union officials were fighting it, so Governor Docking vetoed the bill. Later we found out the Governor received nearly $30,000 in contributions from Kansas AFL-CIO officials during his last campaign. Part of the dues I am forced to pay will probably wind up helping elect politicians who are favored by the union officials.

Statement of

Mrs. J. M. Ford
ILU Member
Lawrence, Kansas

to the

SENATE FINANCE COMMITTEE

on H. R. 13270

October 3, 1969

Mr. Chairman and Members of the Committee:

I am Mrs. J. M. Ford, of 1941 Emerald Drive, Lawrence, Kansas. Mr. Ford and I had two sons in college and we are very much interested in tax reform, especially if tax reform will provide us tax relief.

Both my husband and I are employed. Our employer is Hercules Incorporated, which operates the Sunflower Army Ammunition Plant. I work in the laundry department cleaning coveralls which all employees in powder production must wear. I have been employed by Hercules for the past four years.

As I understand it, the tax reform bill approved by the House of Representatives will levy a tax on the income received by churches on their investments in unrelated businesses. I don't object to that feature of the bill. But I do object to the failure of the House bill to propose a tax on the unrelated business income of labor unions.

I also object to the favored treatment unions receive with regard to political activities. The bill will impose a severe tax on tax-exempt foundations if any of their money is used for any kind of political program -- including voter registration campaigns. But I can't find anything in this bill which says labor unions will also be taxed if they spend money for voter registration drives or other

political activities.

Why are the labor unions entitled to preferential treatment?

One thing can be said in defense of the political activities of foundations: at least they are using money which has been given voluntarily.

The unions, on the other hand, are financing their politicking with funds taken from workers who are victims of compulsory unionism.

This is an outrage, and I hope you gentlemen on the Committee agree it is an outrage.

In Kansas recently the Emporia Gazette criticized this bill because it has tax loopholes benefitting labor unions that earn income from business investments and also support politicians who find favor with the Union Hierarchy. The Gazette said, "It is now time for the public -- union members included -- to join in the cursade to close all tax loopholes." I am a union member who says "Amen!" to that. Mr. Chairman, I aske that the Gazette editorial be made a part of the record of this hearing.

Recently I also read in the newspapers that the National AFL-CIO president appeared before this Committee to speak for what he called "tax justice." I can't see any justice in compelling workers like me to pay dues to a tax-exempt union that spends our money to elect political candidates we workers are against.

Earlier this year our state legislature passed a bill favored by every worker I know. But the union officials were fighting it, so Governor Docking vetoed the bill. Later we found out the Governor received a total of $30,000 in contributions from Kansas AFL-CIO officials during his last campaign. It's

pretty clear to me that Governor Docking isn't going to side with us in the future if the union officials are against the things we workers are for.

Just one year ago this month I was approached in the laundry department of the Sunflower Plant by an officials of Local 605 of the International Laborers Union. She told me the company had agreed to include a "union shop" clause in its new collective bargaining agreement with Local 605. She said I would be fired from my job if I failed or refused to sign a card authorizing the deduction of monthly union dues from my paychecks.

The loss of my income would deny my sons their college educations. So, I reluctantly signed the card, and ever since my employer has been checking off union dues from my wages.

I believe -- and all the Sunflower employees I know believe -- that during the contract bargaining sessions last year officials of Local 605 eagerly accepted a meager wage increase for the employees in order to induce the company to agree to their demands for a compulsory "union shop" clause.

It should be obvious to everyone that some workers want to join and support labor unions and other workers don't want to join and support labor unions. Why aren't the rights of both groups respected? Why aren't the union officials willing to rely on persuasion to enlist new members? Do they have such a low opinion of the services they offer that they're convinced many employees would not support the unions voluntarily? Or do they think most of us are so dumb that we must be compelled to do what they think is the right thing to do?

A year ago I didn't know I was being lied to when I was told I would have to sign a dues check-off card in order to keep my job. Since that time I've learned that a worker cannot legally be compelled to authorize the deduction of union dues from his paycheck. We can be compelled to pay dues, but we can't be required to sign the check-off authorization.

Officials of Local 605 used other forms of pressure in an effort to get the signatures of Sunflower workers on the check-off form. The union's initiation fee was $38.75, and a lump-sum payment was demanded from employees who balked at signing the form. On the other, the union accepted the fee in installments from those workers who signed the check-off form. Some of the Sunflower employees were dragged ointo the Teamsters Union, and they were compelled to pay a $75.00 initiation fee.

I'm reasonably certain the income received by the local chamber of commerce in Lawrence, Kansas, is tax exempt. Let's suppose its board of directors decided to compel every businessman to pay dues to the chamber as a condition of operating this business in our community. The directors might say, "The services of our chamber benefit every business in Lawrence. Some of these businessmen have been taking a 'free ride' at our expense, and we're going to put a stop to it. They'll either join the chamber and support its program, or we'll run them out of town!"

I strongly suspect the Lawrence Chamber of Commerce would quickly lose its tax exemption if it attempted to coerce non-members in our business community.

There's nothing hypothetical about the coercion used by labor unions. Congress will be shirking its duty if it fails to tax unions' unrelated business income and also if it fails to lift tax exemptions of unions using compulsory dues money to support political candidates and causes.

By being here today, I'm risking reprisals by vindictive union officials. I sincerely hope it is not wishful thinking when I assume the members of this Committee are willing to run the same risk.

Thank you.

OPEN DOORS FOR THE HANDICAPPED
1013 Brintell Street
Pittsburgh, Pennsylvania 15201

Edna Anish
Executive Secretary

Mrs. Margaret Lee Walgren
Legislative Advisor

SUMMARY OF TESTIMONY:

TAX RELIEF FOR THE PHYSICALLY HANDICAPPED

In the summary of the "Tax Reform Act of 1969" which is under discussion, it is stated on Page 2, "the reductions . . . [are] designed not only to remove any tax burden at, or below, the poverty level, but also to provide substantial tax relief for those in the income levels only slightly more capable of bearing tax burdens."

The average income of the orthopedically handicapped, $3400 annually, is precisely at this level. After taxes, the orthopedically handicapped person's income is reduced to poverty level ($1100) by such expenses as transportation, employment, education, housing, domestic help, recreation, hand-controls for specially equipped cars, custom-made clothing, and heavier tipping--all of which are non-deductible.

Almost 500 bills have been referred to Congress on behalf of tax relief for the physically handicapped in the last 14 years. Yet, the "Tax Reform Act of 1969" ignores this problem.

Twenty years ago a precedent for a tax subsidy in the form of a $600 exemption was granted to the visually handicapped (the blind). This was done on the basis of their restricted employability and exceptional expenses.

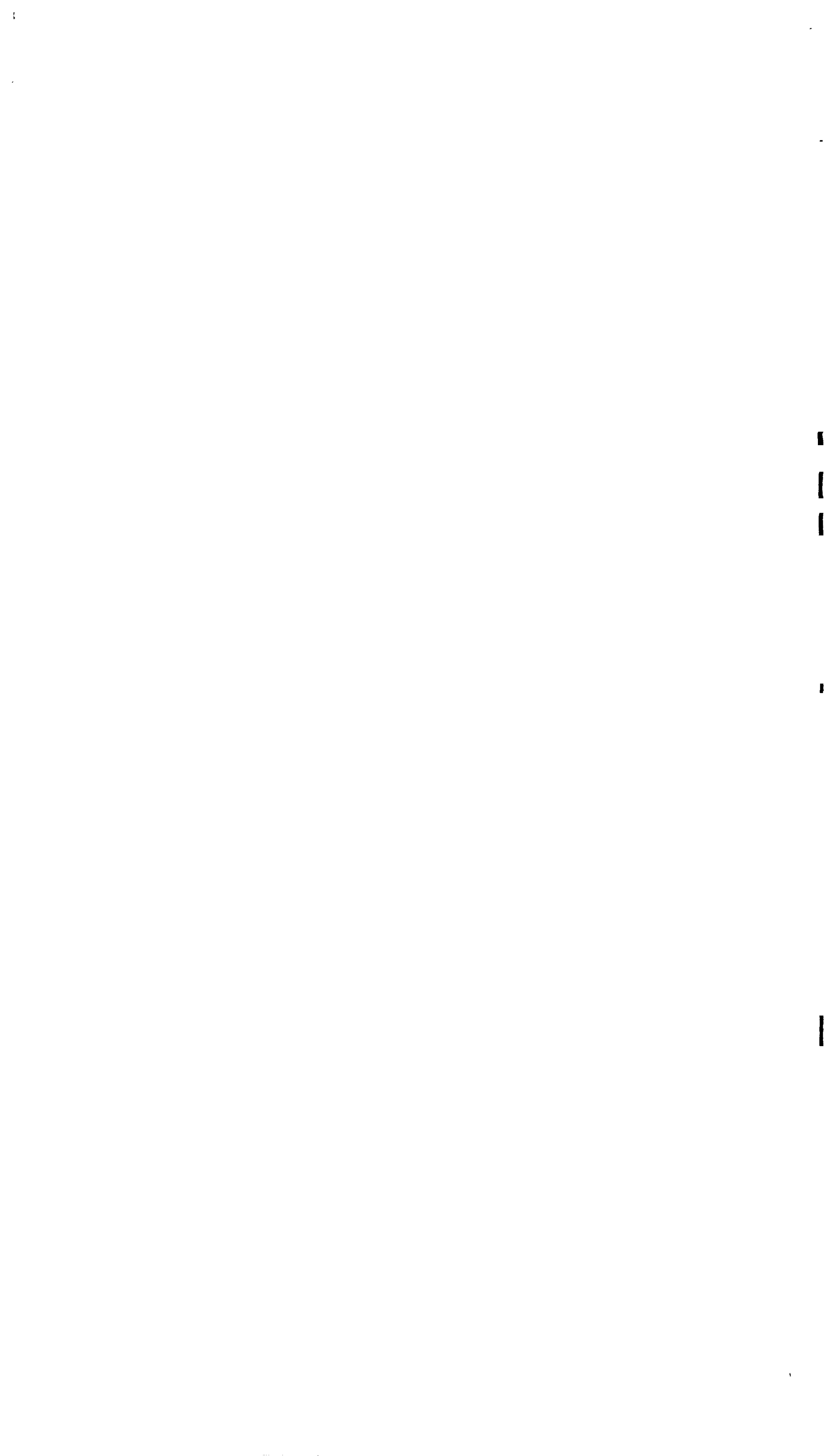
But problems of working and the expenses of living for the orthopedically handicapped are as burdensome, if not more so, than those of the visually handicapped. The same rationale for tax relief should therefore be applied to both categories. Elimination of this obvious inequity in the present tax structure is long overdue.

It has been argued that the technical difficulty of defining and limiting the population who would be eligible for tax relief was so difficult that the problem was better off deferred and ignored. We feel we have come here with an adequate definition of the disabled individual which will be an answer to your dilemma.

Paraphrasing a foremost authority in rehabilitation, Dr. Howard A. Rusk, who quotes from a National Health Survey, we submit the following:

> An orthopedic impairment is defined as a permanent disability of some portion of the skeletal system which has been lost, crippled, paralyzed, or deformed, severely affecting mobility.

We are speaking here for those persons in wheelchairs, persons using braces, crutches, and prostheses; the palsied and the arthritic. We are not asking for a gift; we are simply asking for reasonable and equitable tax relief for orthopedically handicapped Americans; we want to become taxpayers not taxeaters.



HEARINGS ON

TAX RELIEF FOR THE PHYSICALLY HANDICAPPED
before the
Senate Finance Committee
October 3, 1969

Statement of Miss Edna Anish, Executive Secretary,
Open Doors for the Handicapped
Accompanied by Mrs. Margaret Lee Walgren, Legislative Advisor,
Open Doors for the Handicapped

Over the past 14 years upwards of 490 bills (15 in the 89th Congress alone) have been referred to Congress seeking tax relief for the physically handicapped. Not one has been enacted. A cynical explanation might be that all these bills, being so uncontroversial, were merely for home consumption.

Of course, countering this interpretation is the fact that the visually handicapped (the blind) were granted a $600 tax exemption in 1950. You believed then that the low income of this group should be subsidized because of difficulties in finding and qualifying for employment.

But problems of working and the expenses of living for the orthopedically handicapped are as burdensome, if not more so, than those of the visually handicapped. The same rationale for tax relief should therefore be applied to both categories. Elimination of this obvious inequity in the present tax structure is long overdue.

So that you may better understand why we seek tax relief such as the $600 exemption now given to the blind, we bring to your attention the expenses incidental to a disabled person's way of life. Unquestionably, the normal day-to-day activities that the able-bodied take for granted are far most costly in time, energy, and money for us.

Open Doors for the Handicapped promotes the independence of the disabled. This independence costs money! For example:

Transportation.--Public transportation is largely inaccessible to the disabled. The average income of a rehabilitated orthopedically handicapped person is $3400. A clerk typist who goes out to work will spend about one-half of his annual earnings on taxicabs. The breakdown of the earnings of a single, full-time employee in Pittsburgh is as follows:

Annual Earnings		$3400.00
Less taxes:		
Internal Revenue	$402.00	
Surtax	30.00	
Social Security	163.20	
Local City Tax	68.00	663.20
		$2736.80
Taxicabs (annually)		1560.00
Net Income		$1176.80

This, gentlemen, is what our government calls poverty. The "Tax Reform Act of 1969" uses $1100 as the poverty level. We agree! We are paying our government for the privilege of going to work. If this same person did not have the drive and determination to go out to work, he would vegetate at home and collect $1296 Social Security Disability. Then, the total loss to the government is three times what it would gain in taxes if the disabled were to remain employed. Under our present tax structure you are only losing tax revenue, the country is losing our talents, but we are losing our independence, dignity, and emotional stability.

Employment.--Unemployment among the disabled is double that of the able-bodied. The disabled earn less because of the following conditions:

(1) the kind of work they are limited to;
(2) the periodic aspect of that work;
(3) the need to work in sheltered workshops where minimum wage scales do not apply;
(4) they are--or are thought to be--bad risks;
(5) they are unable to enter the competitive labor market and are often exploited by do-gooders;
(6) discrimination still exists.

The Federal government spends more than a billion dollars a year for vocational rehabilitation. It is said to recover, in direct taxes, $10 to every one dollar it spends. Yet it ignores our need for income tax relief. We are being rehabilitated for jobs we cannot afford to keep. The disabled do not want charity or welfare doles; they want to be self-sustaining, self-sufficient citizens. But the disabled person seeking employment faces many problems--primarily financial. With the cost of living rising at a rate of 6 per cent a year, our plight borders on desperation.

Education.--Your next question might well be: Could the disabled get better jobs if he had more education? Yes! But often he is neither financially nor physically able to attend a college of his choice. Only fourteen of more than 2500 colleges and universities in this country meet most of the minimum requirements for accommodating disabled students.

Housing.--Another area which drains our pocketbooks is housing. We cannot live in old housing because of the number of steps. We must live in new apartment buildings or specially designed houses. We therefore have higher rental and housing costs. If a disabled person is lucky--yes, lucky--and earns less than an annual income of $3400, then he is eligible for Federal Housing. But, in reality, he is only eligible for a waiting list because the senior citizens receive priority in these facilities.

Domestic Help.--What of the severely disabled? Not all are fortunate to be able to live at home where family members can lend a helping hand. Very often only slight assistance is necessary, but it is crucial; for example, help in getting from bed to wheelchair in the morning and back at night. Yet, this type of help is not tax deductible for the disabled.

Recreation.--The disabled, especially, needs recreation. But what enjoyment is possible on a low, heavily taxed income? Those seats at

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concert halls reserved especially for the disabled are the most expensive. Also, the disabled must buy first floor theatre seats because they cannot get to the less expensive balcony seats.

Other.--Other non-deductible expenses incurred by the disabled are hand-controls for specially equipped cars for disabled drivers, custom-made clothing, and heavier tipping so often needed for a helping hand.

Without further documentation, we think you will agree that we have made a case for extending a tax subsidy of a $600 exemption to the orthopedically handicapped. The precedent for this subsidy was set twenty years ago on behalf of the blind.

It has been argued that the technical difficulty of defining and limiting the population who would be eligible for tax relief was so difficult that the problem was better off deferred and ignored. We feel we have come here with an adequate definition of the disabled individual which will be an answer to your dilemma.

Paraphrasing a foremost authority in rehabilitation, Dr. Howard A. Rusk, who quotes from a National Health Survey, we submit the following:

> An orthopedic impairment is defined as a permanent disability of some portion of the skeletal system which has been lost, crippled, paralyzed, or deformed, severely affecting mobility.

Lobbying obviously is a real hardship for us--both physically and financially--so you have not seen us often!

We are speaking here for those persons in wheelchairs, persons using braces, crutches, and prostheses; the palsied and the arthritic. We are not asking for a gift; we are simply asking for reasonable and equitable tax relief for orthopedically handicapped Americans; we want to become taxpayers not taxeaters. Thank you.

Executive Secretary
MAX LUPKIN
Public Relations Consultant
40 First Ave., N Y 10009, Suite 8A

President
MAURICE WARD
Director, Legislation

1st Vice President
EDWIN BEER
Director, Research
66-66 110th St., Forest Hills, N. Y. 11375

THE JOINT HANDICAPPED COUNCIL

A NATION-WIDE ORGANIZATION PROMOTING PROGRAMS TO AID THE HANDICAPPED

720 WEST 181st STREET, NEW YORK, N.Y. 10033
WAdsworth 7-2692

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HON AILEEN B RYAN
HON MARIO MEROLA
HON ROBERT F. WAGNER
HON FRANKLIN D. ROOSEVELT, JR.
(Over)

Please see complete oral statement to substantiate the facts and statistics given in this summary on the "Physically Handicapped".

"Tax Act Reform of 1969",for the Committee on Finance, United States Senate.

This oral statement was given by Mr.Max Lupkin,Executive Secretary, of The Joint Handicapped Council, 720 West 181st Street, New York,New York,10033.

Please insert this oral statement into the record.

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(Over)

INTRODUCTION

Chairman Long and distinguished members of the Senate Finance Committee.

My name is Max Lupkin, I am a volunteer, the executive secretary and public relations consultant for The Joint Handicapped Council, and I am here to-day to represent this organization at this hearing, a nation-wide legislative, service and educational organization, a federation of 40,000 members and organizations. Our headquarters are located at 720 West 181st Street, New York, New York, 10033. I live at 40 First Avenue, Suite 5A, New York, New York, 10009.

Oral statement of Max Lupkin, Executive Secretary, Public Relations Consultant (volunteer), of The Joint Handicapped Council, a nation-wide service, educational, and legislative organization, to the Senate Finance Committee, October 2nd, 1969, at 12 o'clock in the afternoon.

<u>Here are the reasons why H.R.424 (Mills) and S.1069 (Javits), MUST BE ENACTED INTO LAW NOW!!!!</u>

Precedent has already been established, on the need for an <u>additional exemption</u>, (Internal Revenue Code of 1954; also see U.S.Senate Committee on Finance, Hearings on the Internal Revenue of 1954, pages 276-277, on the need for additional exemption for the handicapped).

In order to become productive and tax-payers, and produce an income, the enactment of H.R.424(Mill) and S.1069(Javits) will enable

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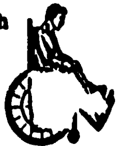
will enable hundreds of thousands of the rehabilitated employable severely handicapped to go to work, and pay taxes, instead of remaining on the welfare rolls to vegetate. The enactment of H.R.424(Mills), and S.1069(Javits) will create a work incentive to these handicapped (many of whom are now on public assistance) by giving them more take home pay because of lowered taxes, and helping them to overcome their high cost living, due to many special and extraordinary expenses not encountered by the non-disabled-- the severely handicapped taxpayers expend as much as $50 weekly for transportation to and from work, as against the non-disabled taxpayer for transportation to and from work at $4 a week using buses, and subways. The severely handicapped taxpayer expends vast sums of money regularly, year in and year out for braces, prosthetic appliances, wheelchairs, wear and and tear of the same and replacement of parts, plus the cost of a new pair of custom-built-orthopedic shoes at the cost from $250-$400 and plus for the repair of these shoes, in order to locomote to and from work.

Our motives are both humanitarian and economical --- and in the case of the Vietnam disabled veterans (amputees) who also desire the oppurtunity for employment, and become taxpayers will be included in these bills.

Our present system of taxation of the handicapped is unfair, unjust and inconsistent with our tax treatment of the blind and the aged.



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We are not asking for any special treatment for the handicapped and/or the disabled amputee veterans, only a fair chance for them to make their contribution to our society, without being penalized by unfair and unjust income tax provisions of the Internal Revenue Code.

In 1964, the full U.S.Senate passed an amendment, introduced by Senator Sparkman of Alabama,(S.201) to H.R.8363, encompassing all the features of H.R.424, but did not become law due to certain technicalities, namely, cost of bill, have overcome in the Bills H.R. 424(Mills) and S.1069(Javits) of 1969: namely, the definition of "disabled" is clear,specific, and meets with the approval of The Treasury Department.(The handicapped taxpayer must have a 40% disability under the Schedule for Rating of Disabilities of the Veterans Administration,Federal Register,volume 29, #1, part2). Cost is only $40 million maximum. The rehabilitated employed and employable severely handicapped and the Vietnam amputee disabled veterans, would be paying taxes to the Treasury Department,and become an asset to the nation instead of a vegetable.

It was pointed out, by Senator Carlson, in the Senate-House Committee discussions on Senator Sparkman's amendment (encompassing all the features of H.R.424) that " in the committee there was no disposition to be opposed to the amendment in regard to the expenses of transportation of the disabled...(Congressional Record, February,1964,page 3402). Further,Senator Long (now, Chairman of the Senate Finance Committee)

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stated, on page 3402, pertaining to Senate amendment S.201 (Sparkman): "*** I am in sympathy with the amendment".

In order to live above the poverty level in to-day's high inflationary costs, the severely handicapped and the Vietnam amputee disabled veterans must earn an income of over $10,500 in the New York City area, only because of their many everyday living expenses, which are far and above those of the non-disabled.

I must repeat, "We are concerned with removing hundreds of thousands of severely handicapped and Vietnam amputee disabled veterans from public and private welfare rolls, by getting them employment and granting them the dignity and self-respect that comes from gainful employment --- which is the principle aim of H.R.424(Mills) and S.1069 (Javits)."

I must repeat, "We are not asking for any special tax treatment for the severely handicapped and the Vietnam amputee disabled veterans, only a fair chance for them to make their contribution to society, without being economically penalized by unfair and unjust tax provisions of the Internal Revenue Code.

I must repeat, "In 1954, a precedent was established for H.R.424, granting the blind and those over 65 an additional exemption for income tax purposes.

Prominent nation-wide organizations with a membership of over 60 million people endorsed H.R.424, including 30 Governors, 13 members/the Ways and Means Committee, Nat'l Council/Churches/Christ(40Million), Methodist Church USA(10 million members), The Tax Committee/Chamber/Commerce, Nat'l Grange, Nat'l Farmers Union, etc.

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Please see written statement to substantiate the complete facts and statistics on the "Physically Handicapped".

" Tax Act Reform of 1969", for the Committee on Finance, United States Senate.

Please insert into the record this written statement, ~~given~~ WRITTEN by Mr. Max Lupkin, Executive Secretary The Joint Handicapped Council, 720 West 181st Street, New York, New York, 10033.

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(Over)

The Joint Handicapped Council strongly urges that H.R.424 (MILLS) and S.1069 (JAVITS) be enacted into law at this session of Congress. In 1964, a companion bill passed in the U.S.Senate but failed to pass in the Joint Committee of both Houses. This legislation is long overdue.

As a group those employed and employable(s) handicapped with severe orthopedic disabilities are in a sub-marginal income bracket requiring federal assistance.

This group is one in which dire poverty is an everyday feature, and total despair and hopelessness their bleak future.

In the past twelve (12) years over four hundred and eighty (480) bill seeking tax equity for the severely orthopedically employed and employable(s) handicapped taxpayer have been introduced in Congress.

H.R.424,(Mills) and S.1069 (Javits), introduced these bills in Congress because for the pressing need for this legislation. It will provide a $600 tax exemption for income tax purposes in the case of an severely orthopedically handicapped taxpayer suffering from a 40% or more loss or loss of use of one or more extremities under the "Schedule For Rating Disabilities of the Veterans' Administration" (Federal Register, Volume 29, #101, PartII). Deductions of up to $600 for special transportation expenses in going to and from work are also included in this bill.H.R.424(Mills) and S.1069(Javits) will grant tax assistance to those physically handicapped individuals most in need of it, (Please turn to page 2)

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THE JOINT HANDICAPPED COUNCIL

A NATION-WIDE ORGANIZATION PROMOTING PROGRAMS TO AID THE HANDICAPPED
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(Over)

It can root out some of the inequities for the disabled currently existing in our Internal Revenue Code.

The problems of the disabled can be better visualized if we examine some known facts. According to the Vocational Rehabilitation Administration of the Department of Health,Education, and Welfare, 173,594 disabled persons were rehabilitated during the year of 1967. 47% of those rehabilitated in 1965 had one or more dependents while 34% needed surgery and treatment.

Each year there is a backlog of 70% of referrals for vocational rehabilitation in 1967, and these 173,594 individuals mentioned above were accepted,while 396,313 were not rehabilitated, under our rehabilitation laws.

Some of the expenses the handicapped are subjected to are as follows:

The average nation-wide cost of prosthetic devices in 1963 was $172 per rehabilitant,according to the U.S.Vocational Rehabilitation Administration. In 1964, The Joint Handicapped Council,720 West 181st Street,New York,New York, claimed that the average person does not obtain prosthetic devices at such modest prices. In the New York City are at that time the going rate was $500 for the cost of a full artificial leg, $450 for an artificial leg below the knee,etc. Other typical costs for the rehabilitant include bilateral brace $350(for brace extended to trunk add $50); brace above the need $250-$350; brace below the knee #100; standard wheelchair $200; special custom-made-orthopedic shoes averaged $120-$175 for the first pair and $85 - $100 for the second pair.

Out of their meager earnings, the orthopedically handicapped, (PLEASE TURN OVER)

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(Over)

by reason of their disabilities, are forced to expend large sums of money they can ill afford to maintain their rehabilitated status.

According to The Joint Handicapped Council, the most frequently recurring expenses the handicapped are subjected to are:

1. Those expenses made for the purchase, repair and replacement of orthopedic and prosthetic devices which are entirely deductible under the medical deduction provision of the income tax law. Special-custom-built- orthopedic shoes fall in this catagory.

2. Unusual wear and tear of clothing caused by constant friction of orthopedic and prosthetic devices, crutches and by falling.

3. Additional expenses often include higher cost of apartment rentals due to need for ground floor quarters or elevator apartment accommodations.

4. Many disabled persons find it necessary to take taxicabs daily going to and from work. In the New York City are, the average cost for this type of transportation is about $50 weekly.

5. In approximately 10% of the cases, the disabled, as defined in H.R.424(Mills), and S.1069(Javits) find it necessary to purchase automobiles to give them mobility in going to and from work, etc. These automobiles, of necessity, must be kept in top condition (entailing more expenses) to avoid mechanical failure. Hand controls have to be installed in a majority of instances.

A business man is permitted to deduct the cost of his motor vehicle as well as vehicular expenses for the production of income,

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(Over)

<u>while his physically handicapped employee who needs his car for production of income cannot</u>, despite the fact that he might be in a wheelchair, wear heavy braces, use crutches, be an amputee, for some other extenuating reason.

6. Paraplegics often find it necessary to purchase homes which are specially equipped with fixtures installed at lower levels. Ramps and wider doorways must be built to allow for ingress and egress to and from their homes.

7. The physically handicapped are frequently compelled to hire someone to do the household cleaning and repairing.

8. Due to discrimination in hiring practices the disabled are frequently forced to accept lower wages and salaries. This is a hidden expense not apparent to the eye.

9. Those handicapped individuals who can afford life insurance to protect their loved ones are considered sub-standard risks and as such are required to pay higher life insurance premiums.

The handicapped are also frequently rejected for health and accident insurance, and as a result have to pay higher medical and hospital expenses than the average taxpayer. These insurance policies do not as a rule cover chronic conditions existing prior to the issuance of such policies, and as a result, corrective operations for physical improvements are not covered.

When one considers the aforementioned problems confronting the physically handicapped and then ties them in with the current high cost of living, ----- PLEASE TURN TO PAGE 5

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one is amazed at the obstacles which they must surmount. Despite heavier expenses, the handicapped are forced to pay the same tax, with the same deductions as the able bodied.

Often, after rehabilitation, the handicapped, confronted by a combination of low wages, high cost of living, high cost of going to and from work, soon become disillusioned with the high cost of maintaining their rehabilitated status. Many are thus driven into staying at home, since their low income, less the above mentioned expenses, gives them lower net income than if they stayed at home as a welfare recipient.

According to the United States Statistical Abstract, issued in September, 1968, job placements through public employment offices of handicapped workers during 1967, amounted to 1.9% of the total number of placements made in the United States in the last 20 years. However, 1.9% is apparently too high a figure when one considers that the handicapped are rarely placed through private employment agencies, and since, percentage wise, public employment offices place a much higher percentage of handicapped workers.

By taking 1.9% of the 77,347,000 total civilian labor force for the year of 1967 we get a theoretical total of physically handicapped working population of 1,469,593 including every type of disability. However, in 1967, out of 173,594 rehabilitants, approximately 37% included muscular skeletal, and amputees. If we multiply 1,469,593 by .37 we get 543,375, of the 543,375 approximately 14.4% of the 37% includes severe cases, and approximately 22.6% of the 37% includes less severe cases, so that a further

(Over) breakdown — PLEASE TURN OVER —

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breakdown reveals that of the 543,375 muscular, skeletal and amputee cases, 211,392 represent severe cases and 331,768 represent less severe cases. Allowing for a possible 100,000 borderline cases between severe and less severe to possibly qualify under H.R.424 and S.1069, we can assume that approximately 311,392 handicapped individuals would qualify under this legislation.

Even if all 311,392 disabled taxpayers claimed the $600 exemptions with a savings of $120 each, the total savings in income taxes, for the disabled taxpayers would be $37,366,040. If as many as 15% of the 311,392 disabled taxpayers took advantage of the transportation deductions allowable under H.R.424, it would save them a total of $5,604,960. The grand total for both types of income tax savings would be a maximum of $42,971,000. The $42,971,000 total will be further reduced by tax reforms affecting the low income bracket.

<u>This bill is intended to include severely disabled employable veterans of present and past wars as well as those employed and employables who have been severely handicapped by disease, amputation and other causes.</u>

In 1963, it cost the government an average of from $479 to $544 to rehabilitate an orthopedically handicapped person. For the balance of his or her life, the rehabilitated individual will have to purchase, place and repair all sorts of prosthetic devices specially custom-built-orthopedic shoes, specially built braces, crutches, wheelchairs, hand controlled automobiles, to say nothing of additional corrective surgery. PLEASE TURN TO P.7-

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Granting tax aid under H.R.424(MILLS) and S.1069 (Javits) would lighten somewhat the heavy burden borned by the employed handicapped taxpayer.

Some years ago, the U.S.Tax Court denied handicapped taxpayers deductions for transportation expenses to and from work, holding that these are merely commuter expenses. The orthopedically handicapped person who must use his car for going to and from work, is using it for the production of income. He cannot produce income without using his car for mobility. H.R.424(Mills) and S.1069 (Javits) would aid him by allowing deductions of up to $600 where they are presently disallowed.

And, to sum up, enactment of H.R.424(Mills) and S.1069(Javits) in this legislative session, is both necessary and crucial for the severely handicapped.

Respectfully Submitted,

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Summary of Statement of
H. Francis DeLone

The American Bar Association opposes legislation to make non-deductible payments in satisfaction of private antitrust treble-damage claims or actions because:

1) Such claims or actions are remedial, not punitive. Payments to satisfy them are "ordinary and necessary expenses" deduction for which should be allowed since such deduction does not "frustrate sharply defined national" policy.

2) The tax laws should not be manipulated to achieve, indirectly, antitrust goals which can and should be achieved directly through the antitrust laws and amendments to them.

3) Similar payments are deductible.

4) The antitrust laws are necessarily imprecise; their interpretation depends on complex and difficult economic analysis, allowing a wide range of culpability, so that inequities will result from any blanket rule of non-deductibility of such payments.

5) The proposed legislation creates possibilities of double taxation and, perhaps, windfall tax treatment, and would contribute to further court congestion.

6) The proposed legislation raises problems of retro-activity and ex post facto application which cannot be justified on the basis of any claimed deterrent effect.

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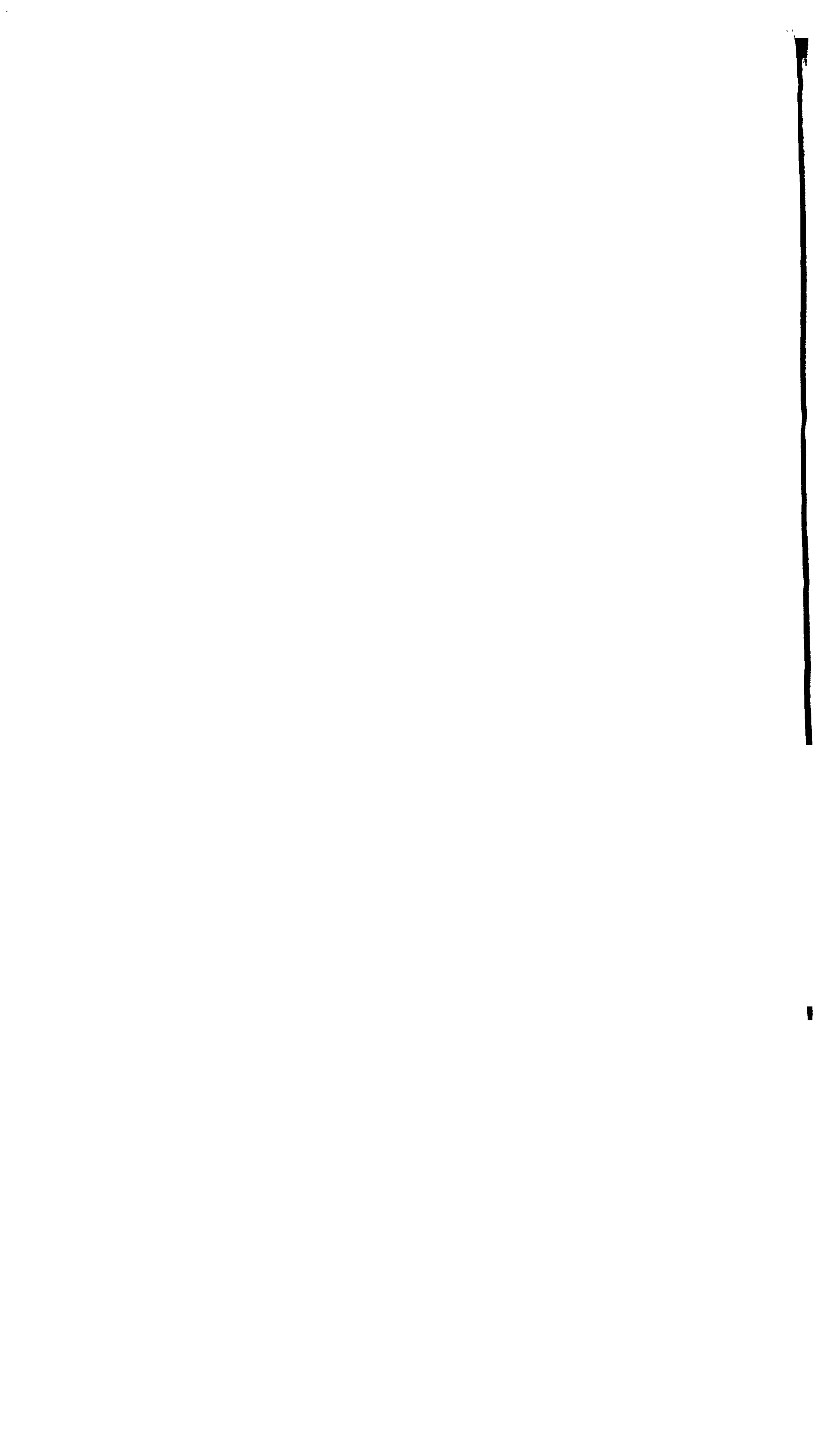

Statement of H. Francis DeLone, Chairman, Clayton Act Committee, Section of Antitrust Law, American Bar Association, Concerning Proposed Legislation Designed to Make Antitrust Damage Payments In Whole Or In Part Non-Deductible

In January of 1969, the House of Delegates of the American Bar Association adopted the following resolutions:

> RESOLVED, that the ABA disapproves any proposed legislation having the purpose to make non-deductible for federal income tax purposes all or any portion of payments made in satisfaction of antitrust treble-damage judgments or claims; and further
>
> RESOLVED, that the Section of Antitrust Law and the Section of Taxation are authorized to urge the views of the American Bar Association in this regard upon the Joint Committee on Internal Revenue Taxation and other appropriate committees of Congress.

These resolutions were adopted on the basis of a report submitted to the House of Delegates by the Sections of Antitrust Law and of Taxation of the American Bar Association. The balance of this statement consists of that report, with certain technical revisions made necessary by events which have occurred since the report was originally prepared.

REPORT

The starting point for a discussion of this matter is Revenue Ruling 64-224, issued July 24, 1964.[1/] That ruling allows income tax deductions for amounts paid or incurred to satisfy claims for damages as well as for amounts paid or incurred for legal fees and directly related expenses in connection with private treble-damage suits under Section 4 of the Clayton Act. Additionally, the Ruling disallows deductions for amounts paid or incurred in satisfaction of damage claims by the United States under Clayton Act Section 4A. This had continued to be the announced position of the Revenue Service, consistent with Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).[2/] Also, the Ruling disallowed deductions for legal expenses incurred in unsuccessfully defending actions under Section 4A -- a position implicitly overruled by Commissioner v. Tellier, 383 U.S. 687 (1966), and subsequently modified by Revenue Ruling 66-330, 1966-2 C.B. 44.

1/ 1964- 2 C.B. 52.

2/ Statement of Sheldon S. Cohen, Commissioner of Internal Revenue, Hearings Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, 89th Cong., 2d Sess. (1967) [hereinafter cited as "Hearings"], p. 85.

Revenue Ruling 64-224 was issued as a result of the so-called Philadelphia Electrical Cases,[3/] which resulted in hundreds of millions of dollars in treble-damage recoveries by private plaintiffs. Prior to this time, the Internal Revenue Service had evidently never denied a taxpayer a tax deduction for such treble-damage payments;[4/] and the closest published precedent, regarding treble-damage payments under the Emergency Price Control Act of 1942, allowed a deduction.[5/] In 1961 the Service considered opposing such an allowance for antitrust treble-damage defendants. However, the Service conducted conferences and extensive further studies extending into 1963. Based on the findings of this extensive study, the indications that Section 4 of the Clayton Act was intended to be remedial rather than to punish defendants,[6/] and the

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3/ Staff Study of Income Tax Treatment of Treble Damage Payments Under the Antitrust Laws for the Joint Committee on Internal Revenue Taxation, Committee Print 1965 [hereinafter cited as "Staff Study"], p. 21.

4/ Statement of Mortimer M. Caplin, Hearings, p. 62.

5/ I.T. 3627, 1943 C.B. 111, held that treble-damage payments to a private party by a violator of the Emergency Price Control Act of 1942 were tax deductible since the payments were considered remedial in nature.

6/ Contra, Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (dictum).

Supreme Court's unwillingness, except in rare instances, to disallow business expense deductions on "public policy" grounds,[7/] the Service ruled that treble-damage payments in antitrust cases are deductible.[8/]

The American Bar Association recommends that any legislation designed to make antitrust treble-damage payments in whole or in part non-deductible for federal income tax purposes be disapproved for the following reasons: (1) enactment of such legislation would fail to reflect the remedial rather than punitive nature of treble-damage actions; (2) basic tax principles delineating federal taxation as a tax on net income and not a sanction would be disregarded; (3) payments similar to treble-damages are fully deductible; (4) the economic analysis of antitrust questions frequently makes interpretation of the statutes difficult, allowing for a wide range of culpability, to which such legislation is not responsive; (5) inequitable tax effects would be created; and (6) any possible retroactive effect would be unfair.

7/ But see, Tank Truck Rentals, Inc. v. Commissioner, supra.

8/ For a full discussion of these developments, see Statement of Mortimer M. Caplin, Hearings, pp. 59-63; and Statement of Sheldon S. Cohen, Hearings, pp. 84-88.

1. Treble-Damage Actions as Remedial or Punitive: Public Policy Considerations

To the extent that Revenue Ruling 64-224, in allowing deduction of treble-damage payments, was founded on the determination that Clayton Act Section 4 actions are "remedial" rather than criminally punitive, both its rationale and its conclusion appear to have been supported and confirmed by the Supreme Court's reasoning in Commissioner v. Tellier, supra, decided March 24, 1966. In fact, this case, by strictly delineating "violation of public policy" as the test for disallowance of deductions, would seem to diminish the importance of the "remedial-penal" dichotomy.[9/] In all events, that Section 4 of the Clayton Act is remedial and not penal is apparent both as a matter of statutory construction and legislative history. Recoveries inure wholly to benefit the injured party; other Sherman Act sections specifically punish by fines and prison terms; and the legislative history emphasizes a purpose of encouragement of private actions rather than punishment of antitrust offenders. Moreover, the Supreme Court has described Section 4 as a "remedial provision for redress of injuries," Eastman Kodak Co. v. Southern Photo

9/ See generally, Staff Study, pp. 2-5.

Materials Co., 273 U.S. 359, 373 (1927), and as a "right of action granted to redress private injury," United States v. Cooper Corp., 312 U.S. 600, 608 (1941). The weight of judicial authority likewise affirms the compensatory nature of treble-damage provisions. E.g., Bruce's Juices, Inc. v. American Can Co., 330 U.S. 743 (1947).

Tellier holds that legal fees and related expenses incurred by a taxpayer in the unsuccessful defense of a business-related criminal prosecution (action for fraud against a securities dealer) are deductible as ordinary and necessary business expenses under §162 of the Internal Revenue Code. A subsequent Revenue Ruling based on Tellier reversed that portion of Revenue Ruling 64-224 which had disallowed such fees and expenses in antitrust damage actions by the Government.[10/]

The Court in Tellier primarily addresses itself to the "public policy" issue. In the present context that issue is specifically whether the deduction of treble-damage payments would frustrate any sharply defined policy that Congress had in mind in allowing antitrust plaintiffs to recover treble instead of actual damages; whether the

10/ Revenue Ruling 66-330, 1966-2 C.B. 44.

"sting" of Section 4 of the Clayton Act is thereby lessened.[11/] The Supreme Court has always been reluctant to deny business expense deductions on grounds that their allowance would frustrate national or state policies proscribing particular forms of conduct, and in a number of cases has found this "public policy" argument inapplicable. See Commissioner v. Sullivan, 356 U.S. 27 (1958) (deduction for rent and wages paid by operators of a gambling enterprise sustained, although both the business and the specific payments were illegal); Lilly v. Commissioner, 343 U.S. 90 (1952) (deduction for amounts kicked-back by opticians to doctors to obtain prescription business allowed, although in violation of Section 1 of the Sherman Act); and Commissioner v. Heininger, 320 U.S. 467 (1943) (deductions allowed for attorney's fees in the unsuccessful defense of an administrative mail fraud order).

Contrariwise, the Court has denied business deductions on the ground they frustrated "sharply defined public policies" in only two categories of cases: payments of fines and penalties to governmental bodies, Tank Truck Rentals, Inc. v. Commissioner, supra, and Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958); and payments,

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11/ See Staff Study, p. 6, pp. 25-27.

such as lobbying expenses, specifically prohibited by longstanding Treasury Regulations, Textile Mills Sec. Corp. v. Commissioner, 314 U.S. 326 (1941), and Cammarano v. United States, 358 U.S. 498 (1959).

The Court in Tellier has enunciated a "sharply limited and carefully defined category" for the role of "public policy" in determination of proper business expense deductions, in the following terms:

> Deduction of exponses falling within the general definition of §162(a) may, to be sure, be disallowed by specific legislation, since deductions "are a matter of grace and Congress can, of course, disallow them as it chooses." . . . The Court has also given effect to a precise and longstanding Treasury Regulation prohibiting the deduction of a specified category of expenditures; . . . But where Congress has been wholly silent, it is only in extremely limited circumstances that the Court has countenanced exceptions to the general principle reflected in the Sullivan, Lilly and Heininger decisions. Only where the allowance of a deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct" have we upheld its disallowance . . . Further, the "policies frustrated must be national or state policies evidenced by some governmental declaration of them." . . . Finally, the "test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." 383 U.S. at 393-94.

It seems clear, therefore, that the rationale of Revenue Ruling 64-224 on the deductibility of antitrust treble-damage payments has been confirmed by the reasoning enunciated in the Tellier case. We feel that a statutory

amendment to preclude such deductions, either in whole or in part, is not warranted by any possible effects on antitrust policy. Rather, it would be unwise as a matter of both tax and antitrust considerations.

2. Basic Tax Policy Considerations

Any proposed legislation designed to limit or deny the deductibility of treble-damage payments is objectionable as a matter of basic tax policy on the ground that manipulation of tax provisions should not be used to achieve social goals in other areas. There is virtually no disagreement that any departure from this position should be made only if it is otherwise necessary and meritorious; only for clearly valid and carefully considered reasons.[12/]

The Supreme Court in the Tellier case has reiterated this position, stating: "We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning." 383 U.S. at 691. The Court cites statements of the late Randolph Paul, as well as the original 1913 floor-debate statements of Senator Williams, to the same effect. 383 U.S at 691-92 and n. 11, p. 695.

12/ See collection of language to this effect in Staff Study, pp. 11-12, and again in Commissioner v. Tellier, supra.

Tax legislation to accomplish a non-tax societal purpose deemed meritorious should be utilized only when it is not "possible to achieve that goal more efficiently, directly, and fairly through other measures which lie outside the realm of the tax system."[13/] We do not think that the tax collector need be made the antitrust enforcer, or that the tax laws need be changed in order to achieve a further and greater dollar punishment. Certainly here there is another way to solve any enforcement deficiencies within the legal context of the substantive area of concern. The antitrust laws themselves present the direct and manageable opportunity for increasing penalties, if such is deemed necessary. Simply quadruple or quintuple damages, if the deterrent is not currently enough, before abrogating basic policies by interfering with the tax deductibility of damage payments.[14/]

3. Payments Similar to Treble-Damages Are Deductible

We have noted that the Supreme Court in Tellier has reemphasized its reluctance to find that the allowance of

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13/ Remarks by Hon. Stanley S. Surrey, Asst. Sec. of the Treasury, before the Tax Executives Institute, March 7, 1965.

14/ See Statement of William Simon, representing the American Bar Association, Hearings, pp. 35, 43, 45.

an otherwise tax-proper business expense deduction would "frustrate sharply defined national or state policies proscribing particular forms of conduct," citing many of its own previous decisions wherein the deductibility of payments similar to antitrust treble-damages have been upheld. The enactment of legislation on this subject would be particularly inadvisable to the extent that it singles out antitrust treble-damage payments for interference with their tax deductibility. Both the courts and the Internal Revenue Service have long held similar, if not identical, payments deductible. These include "kickback payments" clearly in violation of Section 1 of the Sherman Act; payments made in settlement of treble-damage actions for price ceiling violations under the Emergency Price Control Act of 1942; multiple damages paid to an employee for violations under the Fair Labor Standards Act; payments made in connection with violations of the law in the sale of securities; various fraud case payments; and the rent and wage expenses of an illegal gambling operator where these expenses were themselves a separate violation of a state law. 15/

15/ Respectively, Lilly v. Commissioner, supra; Jerry Rossman Corp. v. Commissioner, 175 F.2d 711 (2d Cir. 1949); I.T. 3762, 1945 C.B. 95; Ditmars v. Commissioner, 302 F.2d 481 (2d Cir. 1962); Laurence M. Marks, 27 T.C. 464 (1956); Rev. Rul. 61-115, 1961-1 C.B. 46; Helvering v. Hampton, 79 F.2d 358 (9th Cir. 1935); Heininger v. Commissioner, supra; Commissioner v. Sullivan, supra.

Tellier, of course, has clearly settled any issue regarding the deductibility of legal and related expenses in defense of any such actions, criminal or otherwise.[16/]

To reverse the basic tax policy noted above and as reaffirmed in Tellier, that federal income taxes should be on net income and not contorted to implement various regulatory statutes or to punish wrongdoing, is the prerogative of Congress. But one situation should not be singled out for such special treatment. Only after a thorough consideration of a broad range of items affecting enforcement of public laws and policies should legislation of this type come before the Congress.

4. Interpretation of the Antitrust Statutes Is Frequently and Generally Difficult, Allowing For a Wide Range of Culpability, and Resultant Inequities Under the Proposed Legislation

The antitrust laws are dynamic in nature and their boundaries are often imprecise. Our antitrust laws are as equally economic, social and political as they are legal. Antitrust is involved in the sensitive area of what is good for the economy. Certainly businesses and governmental agencies have made unforeseeable mistakes, and the

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16/ These cases and Rulings, including Sullivan, Lilly and Heininger, supra, are analyzed in Statement of William Simon, Hearings, pp. 35, 37-41.

courts themselves have experienced great difficulty with the economic analysis necessary to determine whether a violation has occurred.[17/]

Businesses are going to become subject to treble-damage actions in spite of every effort to avoid antitrust violations. In Simpson v. Union Oil Co., 377 U.S. 13 (1964), the Supreme Court held that a consignment agreement providing a resale price limitation violated the Sherman Act, although the Court approved a similar consignment agreement 38 years earlier; thus, its decision raises "the distinct possibility that an untold number of sellers of goods will be subjected to liability of treble damage suits because they thought they could rely on the validity of this Court's decisions." 377 U.S. at 30 (Justice Stewart dissenting). In 1967, the Court, in United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967), again indicated that consignment agreements and agency arrangements may properly be used by a manufacturer, within certain limits, to control the distribution of his product. In FTC v. Fred Meyer, Inc., 390 U.S. 341 (1968), decided on March 18, 1968, the Court held "for the first time, 32 years after the passage of the Act," that Section 2(d) of the

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17/ See Statement of William Simon, Hearings, pp. 35, 41-42.

Robinson-Patman Act, which requires equal promotional allowances by suppliers to all customers, uses the word "customers" to include persons who did not purchase directly from the supplier but bought through intermediate wholesalers. In so defining "customers" to include "non-customers whom the Court thinks need protection," (see dissenting opinion, 341 U.S. at 361), the Court adopted a theory neither party proposed.

The very governmental agencies enforcing the antitrust laws experience difficulty in determining whether a violation has occurred. In 1963, the Justice Department found itself in disagreement with the Federal Trade Commission as to whether price-quoting cooperative advertising by independent retail druggists constituted illegal price-fixing under the Sherman Act.[18/] In Purolator Products, Inc. v. FTC, 352 F.2d 874 (7th Cir. 1965), cert. denied, 389 U.S. 1045 (1968), the Solicitor General filed an amicus brief opposing the Federal Trade Commission position.

Finally, the courts themselves have had admitted difficulty with the economic impact of business arrangements in reaching a conclusion regarding their classification under the antitrust laws. See White Motor Co. v. United

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18/ See H.R. Report No. 699, 88th Cong., 1st Sess. 1 (1963).

States, 372 U.S. 253 (1963).

Within the above context, denying deduction for treble-damage payments, either in whole or in part, would arbitrarily impose "a burden in a measure dependent not on the seriousness of the offense," Tellier, supra, at 695. It has traditionally been the province of the courts to fit the punishment to the crime in the imposition of sentences. This can be particularly important when offenses can be inadvertent or less than deliberate. As noted by the chief counsel for the Senate Subcommittee on Antitrust and Monopoly, in all of the price ceiling treble-damage cases the courts had discretion regarding damages.[19/] Obviously, the tax collector is and should be blind to whether and to whom social good comes or doesn't come from the collection of taxes. The Antitrust Division, of course, properly exercises certain discretion in how it enforces the laws it is charged to uphold. But just as certainly, it should not be within the province of the Antitrust Division to further determine against whom the tax laws should be made available to inflict an additional penalty, as would be true under the provision of legislation which would limit the denial of a deduction to cases where there has been a

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19/ Hearings, p. 55.

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criminal indictment resulting in a judgment of guilt or a nolo contendere plea. This allows the tax effect to the violator to be too much the result of prosecutor discretion[20/] in light of the fact that civil injunctions of per se antitrust violations require much the same showing by the government as do criminal proceedings, and that criminal convictions can be obtained without direct evidence of intentional wrongdoing. Making the deductibility of subsequent treble-damage payments dependent on the government's choice of a civil or criminal enforcement route seems illogical when that choice is not necessarily reflective of the relative "hard-coreness" of the violation.[21/]

5. Inequitable Tax Effects

Legislation in this area creates possibilities of double taxation and perhaps even windfall tax treatment on the other side -- unjust but inevitable when alterations are imposed on the basic policy of taxing net income.

20/ See letter from Asst. Prof. Meade Emory to Senator Hart, Aug. 2, 1966, with excerpt from article, Hearings, pp. 109, 110-112.

21/ In this regard, note the refusal of the Justice Department to give reasons why it brought a civil instead of a criminal action even in the face of a Court order to produce, United States v. Venice Work Vessels, Inc., April 4, 1968 (ATTR No. 356, May 7, 1968, p. A-2).

We have noted the difficulty of equating "wrongdoing" with treble-damage awards or settlements. Certainly it is at best arguable whether the profits made by a treble-damage defendant bear any necessary relation to damages he may be required to pay as a result of suits brought against him. However, to the extent he has so profited from his alleged wrongdoing, the treble-damage defendant has paid tax on this additional income. To the extent damages represent a repayment of such profits, it would seem that denial of a deduction to defendants would result in double taxation.

Additionally, we note that the actual increase in deterrent value of any such legislation is subject to question. The then Acting Attorney General Katzenbach noted in 1965 that with the present corporate tax rate of almost 50 percent, an adjudicated treble-damage violator, even with deductions, will be out-of-pocket approximately 150 percent of actual damages in a situation where it has already paid income tax on any income derived from the violation. That figure, in addition to the expense and business disruption occasioned by the legal proceedings, he suggested, means that even with deductions a potential violator will not likely risk a treble-damage action.[22/]

22/ Letter from Acting Attorney General Katzenbach to Laurance N. Woodworth, Chief of Staff, Joint Committee on Internal Revenue Taxation, Feb. 8, 1965, Staff Study, pp. 61-62.

Moreover, if nondeductibility is limited to cases with respect to which there was a criminal judgment or _nolo_ plea, defendants clearly would be discouraged from entering _nolo_ pleas which would then make them vulnerable to tax sanctions in subsequent treble-damage litigation. The effect would be especially onerous to smaller companies upon whom the high cost of litigation would often be seriously burdensome, if not fatal, to their ability to compete.[23/] And to so discourage _nolo_ pleas would add to the burden of already congested court calendars.

Under present procedures the character of a treble-damage recovery determines its tax treatment.[24/] Amounts received above actual damages are taxable as ordinary income. Recoveries representing single or actual damages are not taxable if they can be shown to represent a return of capital, but are taxable to the extent that they represent lost income or profits. If this rule is changed by legislation to provide, for example, that the two-thirds portion of treble-damages which is nondeductible by defendants is non-taxable to the plaintiffs, a tax windfall for treble-damage payments is created to the extent such

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23/ See Staff Study, pp. 38-39.

24/ Rev. Proc. 67-33, 1967-35 I.R.B., p. 26.

damages represent lost income or profits. In addition, these consequences would be undesirable since they would, to some extent, remove an incentive for treble-damage plaintiffs to settle for single damages.

6. Retroactivity of Any Proposed Legislation

We also disapprove of the retroactive effect of any proposed legislation in this area. It was the recommendation of both the Joint Committee[25/] and the Department of Justice[26/] that such provisions should only apply respecting violations occurring after the date of enactment. At minimum, this retroactive feature would result in unfairness without serving the asserted basic purpose of such legislation as a deterrent to antitrust violations. Although it may be settled that retroactive tax legislation is generally constitutional, Assistant Attorney General Turner clearly suggested at the 1967 Hearings that constitutional problems would here be raised where you are dealing with "criminal law and sort of the criminal type sanctions."[27/] Certainly a bill which would impose additional sanctions only on taxpayers who have been convicted or

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25/ Staff Study, pp. 13, 15-16.

26/ Hearings, pp. 27-28, 33.

27/ *Ibid*.

pleaded nolo on criminal antitrust violations would seem to have such a relation to criminality and would in effect be exacting additional punishment against a person or class of persons so as to create ex post facto problems.

CONCLUSION

For all of the above reasons, the American Bar Association opposes any amendment of the Internal Revenue Code which would disallow in whole or in part the deductibility of treble-damage payments. Such payments, arising as they do in the context of a civil action based on business conduct, should continue to be deductible in their entirety as ordinary and necessary business expenses under Section 162 of the Internal Revenue Code.

SUMMARY OF

STATEMENT OF

DR. N. R. DANIELIAN, PRESIDENT

INTERNATIONAL ECONOMIC POLICY ASSOCIATION

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON TAX REFORM

October 3, 1969

MR. CHAIRMAN:

In the current controversy over tax reform we have lost sight of the fact that it all started with the proposal to extend the 10 percent surcharge, and one of the primary purposes of the surcharge enacted in 1968 was to re-establish confidence abroad in the U. S. dollar, the standing of which in international markets had been weakened because of persistent balance of payments deficits. It is pertinent, therefore, to address oneself to this original purpose of the surcharge and to suggest ways in which the balance of payments of the United States may be improved by means of appropriate tax treatment of foreign trade and investment income.

I have just returned from a month's survey of European opinion concerning the international flow of short-term capital, long-term investments, the U. S. balance of payments, and the standing of the dollar in the opinion of finance ministries and bankers. On more than one occasion the suggestion was made to me by officials, as well as private bankers,

that the United States could help itself in encouraging the reflow of earnings from abroad by a more lenient tax treatment of foreign source income. We have now tried on two occasions a punitive approach; first, in the Revenue Act of 1962, and now in the direct foreign investment controls of the Department of Commerce. There is no evidence that these approaches have been very successful. In the accompanying paper which, with your permission, I would like to submit for the record, we make typical suggestions of ways by which this can be accomplished.

Another area in which tax reforms are long overdue is in the treatment of exports. Ever since 1960 it has been government policy to solve our balance of payments deficits by encouraging exports. In all these years, almost a decade, not one single constructive proposal has come up to Congress from the Executive Department to use tax incentives to this end, in spite of numerous studies and reports recommending such action. In the meantime, we have allowed other countries, particularly the European Economic Communities and Japan, to use tax incentives in promoting their exports in our markets.

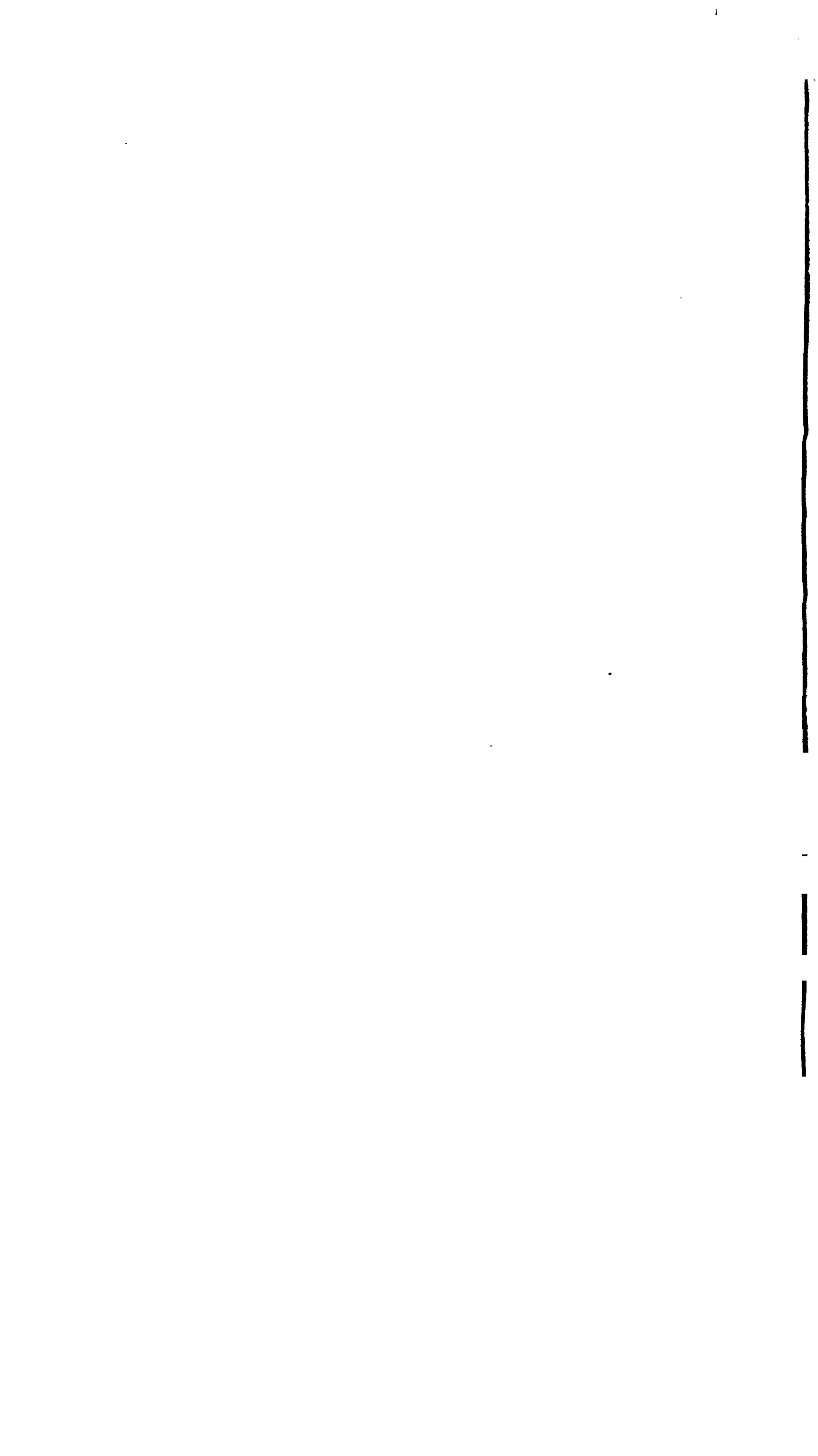
I shall not here recite, for it is well known to you, the evolution of the Common Market's turnover taxes. It is a fact that as late as 1962 we allowed a clarification of the GATT regulations to permit the rebate of turnover taxes and prohibit similar treatment for income taxes. Ever since, we have had our hands tied. Mr. Chairman, we must find a way of liberating ourselves from this self-imposed restraint and give our exporters at least the same effective percentage of tax concessions as our trading partners. We make recommendations in the accompanying paper to achieve this purpose.

There are other means whereby our earnings from exports and from investments can be enhanced and the repatriation of earnings encouraged.

A country with the responsibilities that the United States has assumed in maintaining stability in world conditions will continue to have substantial expenses abroad. Trade policies of other countries being what they are, we may not achieve the necessary surpluses in foreign earnings solely in the area of sales of goods. A large portion, an essential part, in fact, must come from investment and services income. It behooves us, therefore, to encourage rather than discourage profitable investments abroad, because the United States will ultimately become the beneficiary of the earnings from such investments. This part of our international accounts has been the most encouraging -- in fact, the only -- element in our external accounts that has been making a net contribution to our balance of payments. Therefore, we must eliminate unnecessary hindrances to the expansion of this most important source of income.

We make a number of specific suggestions in the accompanying memorandum on ways to achieve this objective.

I am pleased to state for the record that I am accompanied here today by Mr. Charles J. Kerester, Tax Counsel, of the law firm of Jones, Day, Cockley & Reavis, of Cleveland, who is prepared to answer technical questions.



FINANCE COMMITTEE

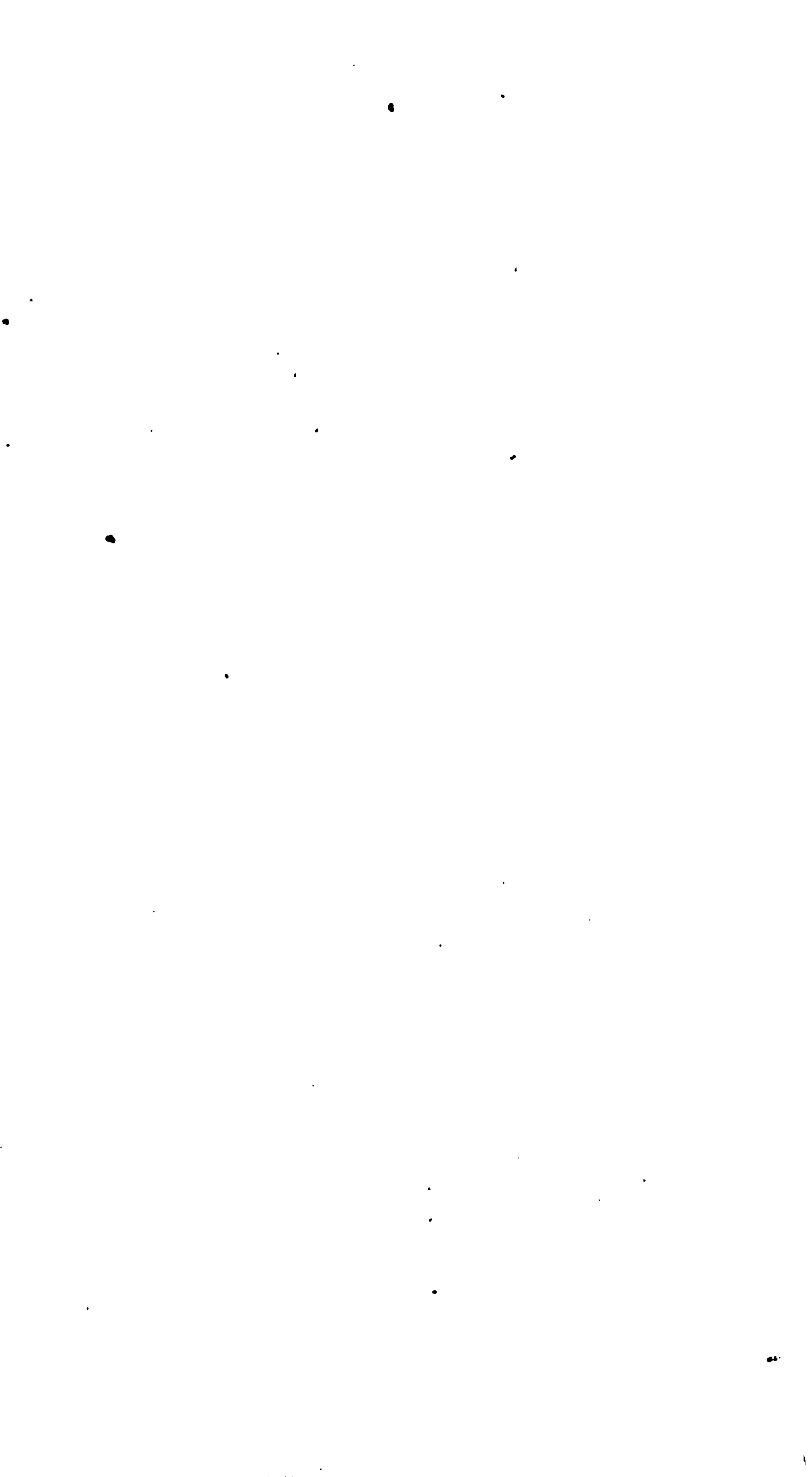
UNITED STATES SENATE

TAX REFORM HEARINGS

H.R. 13270

October 3, 1969

NATIONAL FOREIGN TRADE COUNCIL, INC.
10 ROCKEFELLER PLAZA, NEW YORK, NEW YORK 10020



SUMMARY

The National Foreign Trade Council believes that the "tax reforms" relating to foreign source income embodied in H.R. 13270 should not be enacted into law. Alleged loopholes in the present foreign tax credit provisions do not exist. In addition, sections 431 and 432 of H.R. 13270 and related Treasury proposals are inequitable and discriminatory and should be rejected. Likewise sections 452 and 501 should be rejected for the same reasons.

The National Foreign Trade Council believes that enactment of these sections of H.R. 13270 would create undesirable precedents for the future. It has been a longstanding principle of the U.S. that its nationals are taxed on worldwide income, i.e., that all income be included and all deductions be allowed in determining the net income subject to tax. Rather than exempting foreign source income, the U.S. has provided a credit for foreign income taxes imposed on such income. This has worked in the past to prevent confiscatory double taxation and to protect the U.S. tax properly payable on U.S. source income. All deductions allowable to U.S. nationals deriving U.S. source income should also be permitted to be taken by U.S. nationals deriving income from foreign sources. The foreign tax credit provisions should not be further restricted by adding complex sections which will only add to the growing uncertainty of the tax burden that must be undertaken by our nationals willing to venture abroad.

Section 431 attempts to exact a U.S. tax payment on a loss from operations abroad. Section 431 would depart from the principles of tax neutrality and would complicate the conduct of foreign operations. This recapture provision would penalize nationals conducting operations in underdeveloped nations or risk areas where the possibility of a loss from nationalization or expropriation is greatest. A loss is a loss whether it is incurred in the United States or in a foreign country and a national, taxable on worldwide income, should not be deprived of the tax effect of such an allowable deduction.

Section 432 would segregate and fragmentize income from foreign operations and apply U.S. tax on a per item basis rather than treat such income, either worldwide or from a particular country, as a unit. In addition to discriminating against one industry, the petroleum industry, enactment of section 432 could create an undesirable precedent for the taxation of other types of business income. Section 432 and the Treasury recommendations thereto complicate already complex tax laws without justification for such a departure in the taxation of foreign source income.

Section 452 should not be enacted. It would discriminate against particular industries. Among other things, enactment of section 452 could decrease foreign tax credits otherwise allowable and detract from the relief provided by this Committee in enacting the minimum distribution provisions of subpart F of the Code.

Section 501 discriminates more heavily against the foreign operations of one particular industry than it does against the domestic operations of the same industry. The Council agrees with the Treasury recommendation that section 501(a) should not eliminate percentage depletion with respect to foreign oil and gas production but does not believe that the Treasury's alternative to limit foreign tax credits allowable on a specific type of foreign business income is sound or equitable.

Section 231 should be liberalized to eliminate the $2500 limitation with respect to moving expenses incurred in connection with overseas assignments.

Section 444 should be enacted, but the favorable treatment afforded foreign deposits in U.S. banks should be made permanent and not merely extended through 1975 to avoid the continual threat of withdrawal of foreign funds from U.S. banks.

Section 902 of the Code dealing with direct foreign tax credits should be extended to apply to dividends received from any foreign corporation regardless of the number of tiers of ownership.

Section 367 of the Code relating to advance rule requirements with respect to certain transactions involving foreign corporations, should be repealed.

FINANCE COMMITTEE

UNITED STATES SENATE

TAX REFORM HEARINGS

H.R. 13270

October 3, 1969

STATEMENT OF

NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK

Introduction

The existing foreign tax credit provisions contain no loopholes and accordingly require no tax reform. Therefore, the foreign tax credit provisions, which serve as one of the cornerstones of U.S. trade and investment, should not be amended as contemplated in H.R. 13270 or in the Treasury amendments thereto.

Former Assistant Secretary of the Treasury Stanley S. Surrey stated in his testimony at Hearings before the Senate Foreign Relations Committee with respect to the proposed U.S.-Brasil income tax treaty:

> "American investment would not proceed at all without the foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease." (Senate Ex. J., 90th Cong., 1st Sess., 19, 20.)

Thus, as is widely recognized, the foreign tax credit has, over the years since its adoption in 1918, proven workable and provided the intended relief from double taxation, despite its inherent complexities.

Further complexities have been added since 1962 to the conduct of international business by the enactment of Subpart F of the Internal Revenue Code, sections 951 through 964, and the Interest Equalization Tax, sections 4911 through 4921, and more recently with the promulgation of the regulations under section 482 of the Code and the Foreign Direct Investment Regulations by the Commerce Department in 1968. These laws and the implementing administrative rules have drastically curtailed the freedom of choice of the American investor, and created an environment in which his ability to compete with investors of other developed countries can no longer be taken for granted.

The changes in the foreign tax credit now proposed in H.R. 13270, the Tax Reform Act of 1969, as well as the related Treasury proposals, continue these shortsighted policies of adversely restricting and penalizing the conduct of international business. Contrary to the practice of other industrialized nations which overtly encourage foreign operations on the part of their nationals, the U.S., as evidenced by certain of the provisions of H.R. 13270, is continuing to hamper the conduct of international business on the part of its nationals.

While directed at the U.S. petroleum industry, the proposed changes would overturn longstanding U.S. principles of taxation, the effects of which would extend far beyond the U.S. international

petroleum companies. In addition, if enacted, the proposed changes would then serve as boot strap precedent for future attempts to fragmentize and segregate foreign source income and to tax such income on a per item rather than a net income basis. Moreover, by increasing the tax cost of doing business abroad, the contemplated changes would surely have an adverse impact on our balance of payments in the private international trade and investment accounts - the one sector that has traditionally provided a balance of payments plus for the U.S.

I

U.S. Principles of Avoiding International Double Taxation and Taxation of Foreign Income

Certain of the provisions of H. R. 13270 as well as the Treasury's alternatives thereto proposed by Assistant Secretary, Edwin S. Cohen, at the commencement of these Hearings along with the Council's recommendations relating thereto as well as to other recommendations with respect to the taxation of foreign income should be examined in the light of traditional principles employed by the U.S. in avoiding international double taxation and in taxing foreign income.

International Double Taxation

International double taxation occurs when a national of one country receives income from abroad which is subject to tax both in the country of nationality and in another country.

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This problem is becoming increasingly serious, particularly for those countries, such as the United States, which traditionally have had a vital interest in world trade and investment, as foreign income tax rates range up to and beyond the U.S. rate. Assuming a 50 percent U.S. corporate income tax rate, a U.S. corporation doing business directly in another foreign country such as France, with a tax rate of 50 percent would be subject to confiscatory double taxation. Under these conditions foreign trade and investment could not long endure.

Recognizing this, the industrialized countries of the world, committed to a policy of international trade and investment, have adopted one of two methods for elimination of international double taxation.

One method, based upon the principle of territoriality, is for a country to exempt foreign source income realized by its nationals. The National Foreign Trade Council has long endorsed the exemption method and continues to believe that such method is the more desirable.

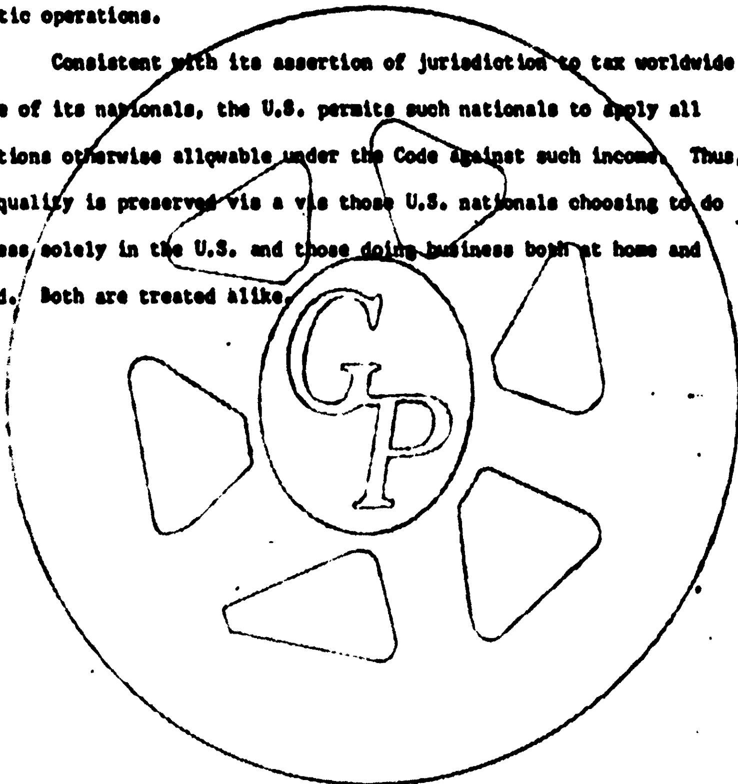
The other method is to tax the worldwide income of citizens, residents and domestic corporations but to grant a credit for the foreign income taxes paid or accrued with respect to foreign source income. Since the Revenue Act of 1918, the U.S. has traditionally attempted to eliminate international double taxation through the use of the foreign tax credit mechanism.

It should be strongly emphasized that both the exemption method and the credit method recognize and give effect to the prior claim of the country of source to tax income arising within its borders.

U.S. Taxation of Worldwide Income

As a country of source, the U.S. asserts primary jurisdiction to tax the income of non resident aliens and foreign corporations derived from carrying on a U.S. trade or business and permits taking deductions provided for under the Code attributable thereto. As a country of nationality, the U.S. asserts jurisdiction to tax the worldwide income of its citizens and corporations. Heretofore, the U.S. has adhered to a policy of not taxing a U.S. national's income derived from overseas operations at a greater rate than that applicable to similar income from domestic operations.

Consistent with its assertion of jurisdiction to tax worldwide income of its nationals, the U.S. permits such nationals to apply all deductions otherwise allowable under the Code against such income. Thus, tax equality is preserved vis a vis those U.S. nationals choosing to do business solely in the U.S. and those doing business both at home and abroad. Both are treated alike.



U.S. Elimination of Double Taxation

However, while asserting its jurisdiction to tax the worldwide income of its citizens and corporations, the U.S. very early in the history of its income tax law recognized the problem of international double taxation. Since the country of source has always the primary right to tax income arising therein, the U.S. under section 901 permits its citizens and corporations having fiscal responsibilities to two national jurisdictions to credit against the U.S. tax the tax paid to the other tax jurisdiction, subject to limitation as to amount under section 904. As long as the foreign tax is considered an income tax or a tax in lieu of an income tax, the U.S. has never required that the foreign taxing system be identical to the U.S. system as a condition of granting a foreign tax credit.

Section 904 of the Code provides for a limitation on the foreign tax credit which prevents any foreign tax paid to another country from being credited against the U.S. tax payable on U.S. source income.* The U.S. concept of eliminating international double taxation

* The U.S. permits its nationals to elect the computation of the foreign tax credit on the basis of either the per country limitation or the overall limitation. The per country limitation imposed by section 904(a)(1) restricts the amount of credit allowable against the U.S. income tax for taxes paid to any single country to the amount of tax imposed by the U.S. on the income derived from that individual country. Section 904(a)(2) provides an alternate overall limitation on the foreign tax credit. The overall limitation restricts the amount of credit allowable by permitting taxpayers to treat the taxes of all foreign countries collectively (rather than separately for each country) in calculating the total amount of credit allowable against the United States income tax on total foreign source income.

Under either system, the U.S. taxpayer must allocate a portion of U.S. expense against foreign income - further reducing allowable foreign tax credits so that the credit for foreign tax is limited to the foreign tax attributable to the net foreign source income, determined under U.S. standards.

under section 904 results, in effect, in foreign source income being taxed at the greater of the U.S. or the effective foreign tax rate. Double taxation is eliminated because the U.S. taxpayer bears the burden of only one tax. The U.S. revenues are protected since the U.S. tax attributable to U.S. source income can never be reduced by any foreign taxes paid on foreign source income.

For example, where the tax rate of country X is 40 percent, a U.S. corporation whose only income is from country X will pay a foreign tax of $40 on taxable income of $100. Assuming a U.S. rate of 50 percent, double taxation is eliminated since the U.S. corporation's $100 of income is taxed at the higher U.S. rate. The corporation credits the $40 country X tax against its U.S. tax of $50, paying $10 to the U.S. Treasury, or a total of $50 tax on taxable income of $100.

If, in the above example, the country X tax rate was 60 percent, the U.S. corporation would credit $50 of country X tax against its U.S. tax of $50 satisfying its U.S. tax liability in full. Double taxation is thus prevented; the total tax of $60 on foreign source income is imposed at the greater of the U.S. or effective foreign tax rate, or at the rate of 60 percent on taxable income of $100.

From the foregoing, it is apparent that the U.S. tax liability with respect to the foreign source income of a U.S. national doing business abroad in countries imposing tax at rates equal to or greater

than the U.S. rate may be satisfied by payment of the foreign tax. This is entirely proper under the credit system of preventing international double taxation where the country of nationality asserts jurisdiction to tax worldwide income of its nationals.

Given the scope and diversity of U.S. business and the firm U.S. policy of insuring that foreign taxes not reduce U.S. tax on U.S. source income, the present U.S. concept of relieving international double taxation through the operation of an elective per country or overall limitation is economically sound and consistent with the policy of tax neutrality.

Since the expansion of international trade and investment is an important national policy, and since such policy can only be attained under adequate protection from international double taxation, any further change in the foreign tax credit system should have the effect of eliminating rather than creating international double taxation. Otherwise foreign trade and investment could not continue, unless of course the U.S. were to adopt an exemption system.

II

H. R. 13270

Sections 431, 432, and 501

1. In General

While sections 431, 432 and 501 of H.R. 13270 are apparently aimed at the extractive industry, they are of much broader impact and could present an unwise precedent for future discrimination against other industries. Enactment of such provisions would produce distorted results which are contrary to the long established policy adopted by the United States of relieving all of its citizens and corporations from the effects of international double taxation. These provisions would result in the U.S. imposing a higher rate of tax on foreign source income than on domestic source income. Moreover, these provisions, if enacted, would further add to the complexities of the U.S. taxation of foreign income.

2. Section 431 Per Country Limitation Restrictions

Section 431 of H.R. 13270 provides for a recapture of U.S. tax where a U.S. taxpayer sustains a loss from foreign operations in a year in which he has elected the per country limitation under section 904(a)(1). For purposes of applying the foreign tax credit limitation in a subsequent year when income is realized from the country in which the loss was sustained, the taxable income from the country in which the loss was sustained (or the taxpayer's foreign source taxable income if

the overall limitation is being used in the subsequent year) is to be reduced by the amount of the loss previously sustained. Thus, taxpayer would be denied up to one half of the credit for foreign taxes actually paid which would otherwise be currently allowable.

The Treasury would propose to extend the operation of section 431 of the Bill to taxpayers on the overall limitation experiencing an overall foreign loss even though in the year of loss no foreign tax credits would be allowed.

Section 431 of the bill also provides for a recapture of the so-called tax saving from a loss sustained in a foreign country where property, which is used in the trade or business from which the loss arose, is disposed of by the taxpayer prior to the time the loss has been recaptured under the rules discussed above. The amount of the loss not previously recaptured is to be included in income for the year in which the disposition of the property occurred, provided the property disposed of is a material factor in the realization of income or loss in the business in which it was used or where the property constitutes a substantial portion of the assets used or held for use in the carrying on of the business. A loss could become taxable income.

Recommendation

For the reasons set forth below, the Council recommends that section 431 not be enacted.

No Double Tax Benefits

As set forth in House Report No. 91-413 (Pt. 1), 91st Cong., 1st Sess., 116, section 431 purports to eliminate two ostensible tax benefits which are said to arise when a taxpayer on the per country limitation experiences losses in a foreign country. The claimed double tax benefits are:

(1) such losses reduce U.S. tax on domestic income; (2) when the business operations in the loss country become profitable, a credit is allowed for foreign paid taxes to that country against what otherwise would be the U.S. tax on the income from that country. Under the U.S. system of taxation, such results can not be labeled "double tax benefits" and do not justify enactment of section 431.

Inconsistent with U.S. Taxation of Worldwide Income. As stated, the U.S. asserts jurisdiction to tax the worldwide income of its citizens and corporations and correspondingly permits such nationals to apply all deductions otherwise allowable under the Code against such income, recognizing that incurring such deductions is essential to the realization of such income.

If the U.S. continues to assert the right to tax worldwide income of its nationals, fairness dictates that such income continue to be subject to deductions wherever incurred. To do otherwise is not to curtail a so-called "tax benefit" but rather to adopt a "heads I win, tails you lose" philosophy of taxation, inconsistent with principles of tax neutrality heretofore adhered to by the United States.

In denying the effect of deductions attributable to foreign source income of U.S. nationals, section 431 results in outright discrimination against income earned abroad. And this will be so at a time when most other industrialized nations are taking positive steps to encourage and increase foreign trade and investment.

Inconsistent with Foreign Tax Credit. The rationale for the foreign tax credit as a method of preventing confiscatory double taxation is that the country of nationality, while taxing worldwide income, gives credit for foreign income taxes actually paid a foreign country on foreign source income. It is difficult to consider the granting of full foreign tax credit up to the amount of U.S. tax on foreign source income a so-called "tax benefit" which should be curtailed.

If one of the reasons for section 431 is that the foreign tax credit should not alleviate double taxation unless the foreign tax is imposed on the identical income as is taxed by the U.S., this is not sound. The foreign tax credit provisions have always recognized that foreign income tax laws cannot be expected to be exactly like the U.S. law, and that foreign income taxes will be computed under differing rate structures, and definitions of taxable income. What counts in a practical sense is the dollar amount of the tax burden in the respective countries. Income taxes paid to two countries on the same business operations constitute double tax-

ation regardless of differences in the structure of the tax laws under which the taxes are paid.

Recognizing that foreign income tax laws do not and cannot precisely reflect the U.S. Internal Revenue Code, the rule of existing section 904 limits the foreign tax credit solely to U.S. tax on foreign source income and thereby affords full protection to the revenues. This rule remains adequate today.

The simple fact is that when foreign operations turn profitable, both a U.S. and foreign income tax will be paid on the same income - and under the foreign tax credit system of alleviating international double taxation, such foreign tax should be credited against U.S. tax, subject to the protective limitation of existing section 904. There is no justification to reduce the foreign tax credit allowable against the U.S. tax on foreign source income because a business operation in a particular country suffered a loss in a prior year. A loss should not create a further tax penalty.

Section 431 Would Penalize Foreign Income

The restriction on the per country limitation imposed by section 431 of H.R. 13270 is inconsistent with, and departs from, basic U.S. principles of taxation since it could result in the taxation of foreign source income at a higher rate than that applicable to domestic income. See Table No. 1, *infra* p. 20. The recapture provisions would reduce the numerator, but not the denominator, of the section 904 fraction (taxable income from country where prior loss arose over entire taxable income) which is multiplied by the U.S.

tax in order to determine the amount of the limitation on the foreign tax credit. The reduction is the amount of the prior year's foreign loss which was allowable under the Code. It is apparently intended that the use of the prior year's loss will reduce the foreign tax credit otherwise allowable against the U.S. tax on foreign source income of the current year.

Any such decrease in foreign tax credits, where the foreign income tax rate is in excess of 50 percent of the U.S. rate, would result in the imposition of an additional U.S. tax on foreign source income to the extent of such decrease. Thus, foreign source income subject to section 431 of the Bill would be taxed at a greater overall rate than comparable income of other taxpayers who never sustained a prior year's loss in foreign operations.

To illustrate, assume that in 1968 Corporation X, a United States corporation, generated U.S. source income of $100 and income from Country Y of $100 and suffered a start-up loss in Country Z of the same amount. Assume further that Country Y and the U.S. imposed income tax at the rate of 50 percent and Country Z at 30 percent, and that Country Z does not allow a loss carryover. Under the overall method of computing foreign tax credits, Corporation X would be considered to have no foreign source taxable income and therefore would be entitled to no foreign tax credits. The $100 of net income would, of course, still be subject to United States income tax of $50. The total tax bill under these circumstances would be 100 percent of the net income ($50 to the U.S. and $50 to Country X). It is this result that the per country

limitation prevents.

Applying the per country limitation under existing law, Corporation X would be entitled to a foreign tax credit of $50 with respect to its $100 of income from Country Y. This credit for $50 of the $50 paid to Country Y offsets the U.S. tax on Country Y's income. The total tax bill under these circumstances would be 50 percent of the net income.

Assume that in the next year taxpayer realized $100 from Country Z and all other facts remain the same. Under existing law, the effective tax rate on Corporation X's income would be 50 percent. If it is further assumed that section 431 applied, the effective tax rate on Corporation X's income for such following year would be increased to 51.6 percent. If on the other hand Country Z's tax rate was 50 percent, Corporation X's effective tax rate for the year following the loss year would, under the application of section 431, be increased to 58.3 percent. Thus, section 431 severely penalizes foreign source income whenever the foreign income tax rate is in excess of 50 percent of the U.S. rate. The degree of penalty depends upon the amount of the foreign tax rate.

Section 431 far exceeds the basic function of section 904 which is to insure that foreign source income will be taxed at no more than the greater of the U.S. or effective foreign tax rate. Moreover, foreign source income will continue to be subject to the penalties of section 431 even though the operation giving rise to the loss has long since been abandoned or is unrelated to the profit operation. Thus, such losses will reduce foreign tax credits arising

from unrelated profitable operations within the same country.

Underlying Premise Incorrect

The complexity of section 431 is illustrated by the fact that the so-called tax benefit recapture provision applies where a foreign loss was sustained in a year when the per country limitation was in effect even though the taxpayer had no income from U.S. sources against which the loss could be deducted. See Table No. 2, infra p. 21a. This is contrary to a statement made in House Report No. 91-413 (Pt. 1) 91st Cong., 1st Sess., 116.

The "recapture" provisions also apply in other situations where the foreign loss can result in no possible U.S. tax benefit. The provisions of section 431 apply where, in the typical case, the foreign country permits a loss incurred in one year to be carried over against income earned in a subsequent year. This carryover, of course, reduces both the amount of foreign tax paid in the later year to the source country as well as the U.S. foreign tax credit, thereby increasing the amount of tax actually received by the U.S. Treasury. Nonetheless, except in the rare case where the income in a country in a year subsequent to the year of loss is twice as much as the amount of the foreign loss in the earlier year, section 431 will operate to reduce foreign tax credits in subsequent years even where the effect of the foreign loss carryover provisions was to increase residual U.S. taxes. See Table No. 1, infra p. 20.

Recapture on Disposition of Property

Section 431 applies upon disposition of property which was materially related to the operation producing the foreign loss. Section 431 would appear to apply even where an unsuccessful foreign venture is abandoned without producing any income. In addition to adding further complexities to the foreign area, this provision is extremely unjust and may have the effect of permanently locking taxpayers into a loss situation, or creating income where in reality income exists, resulting in an uneconomical allocation of resources. This provision represents a significant departure from existing principles of tax neutrality, since a comparable operation in the U.S. could be sold off without tax penalty.

Treasury Proposals

The Treasury proposal to apply the so-called "recapture" provision where there has been an overall loss while using the overall limitation is subject to the criticism set forth above with respect to the loss recapture on the per country limitation. Under the present overall limitation, a loss in one country offsets income from other foreign countries, thereby reducing the numerator of the section 904 fraction (taxable income from foreign sources over total taxable income) which is multiplied by the U.S. tax, so that foreign tax credits otherwise available are lost. Thus, the Treasury proposal provides a double tax penalty for taxpayers experiencing an overall loss while using

the overall limitation. Firstly, foreign taxes applicable to foreign source income which have actually been paid or accrued will not be credited. This is the result under the present law. Secondly, as operations turn profitable foreign taxes otherwise creditable will be reduced by the loss recapture provisions in violation of the traditional U.S. principles inherent in the taxation of foreign source income.

Illustration Showing That Foreign Loss Produces No U.S. Tax Benefits

Table No. 1, set forth below, shows that there is no unwarranted benefit under present law from the deduction of foreign losses by a taxpayer using the per country limitation, and that the proposed provision for recapture of any U.S. tax saving from such deductions of foreign losses would in fact produce international double taxation contrary to the fundamental purpose of the foreign tax credit provisions.

Table No. 1 compares the effect of a loss sustained in a new business and deducted from income of a business in the U.S., followed by income from the new business in later years, under the present law and under the proposed change, according to whether the new business is domestic or foreign and whether the foreign tax law allows or does not allow a net loss carryover. For convenience, it is assumed that both the U.S. and foreign rates are 50%.

Table No. 1 shows that the per country limitation under present law, permitting foreign losses to be in effect deducted from U.S. source income, results in an over-all tax burden of 50% of the cumulative net income over the period during which a foreign loss is sustained and offset by

subsequent foreign income, whether the new business is in the U.S. or in a foreign country. When both businesses are domestic, this results from the application of the 50% U.S. rate to actual net profits. When the new business is foreign, this results under present law from a 50% U.S. tax on the net income over the period, reduced by credit for the 50% foreign tax during the same period. Under the proposed change, the over-all tax burden would be in excess of 50%, the excess being equal to the recapture of the U.S. tax benefit from the loss.

While variations in the U.S. and foreign rates would produce more complicated tables, they would still show the same violation, under the proposed change, of the principle that the net U.S. tax, under the foreign tax credit system of avoiding international double taxation, should represent no more than the excess of the U.S. rate over the foreign rate. The same effect would be shown if there were operations in other foreign countries.

Under column V, the foreign country, as is usually the case, grants a net loss carryover. The foreign tax saving resulting from the net loss carryover automatically produces a "recapture" by the U.S. of the prior U.S. tax benefit of the loss; nevertheless the proposed change in law would exact a second "recapture". When the foreign country does not grant a net loss carryover (column IV) the U.S. recapture results in U.S. tax on income which has been taxed by the foreign country where it was earned.

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Table No. 1

Comparison of Effect of Present Law With Proposal for "Recapture" Under Section 431

Assumed U.S. Rate - 50%; Assumed Foreign Rate - 50%.

	Present U.S. Law						Proposed U.S. Law			
	Case I: Both Businesses in U.S. (unaffected by proposed change)		Case II: Business A in U.S., Business B Foreign, No Foreign Loss Carryover		Case III: Business A in U.S., Business B Foreign, Loss carryover Allowed Under Foreign Law		Case IV: Business A in U.S., Business B Foreign, Loss Carryover Not Allowed Under Foreign Law		Case V: Business A in U.S., Business B Foreign Loss Carryover Allowed Under Foreign Law	
1970										
Business A income	$100		$100		$100		$100		$100	
Business B income	($100)		($100)		($100)		($100)		($100)	
U.S. taxable income	0		0		0		0		0	
U.S. tax before credit	0		0		0		0		0	
Creditable Foreign tax		0		0		0		0		0
U.S. tax after credit		0		0		0		0		0
1971										
Business A income	$100		$100		$100		$100		$100	
Business B income	$100		$100		$100		$100		$100	
U.S. taxable income	$200		$200		$200		$200		$200	
U.S. tax before credit	$100		$100		$100		$100		$100	
Foreign tax		0		$50		0		$50		0
Proposed reduction of credit limitation per section 431							($25)		($25)	
U.S. tax after credit		$100		$50		$100		$75		$100
1972										
Business A income	$100		$100		$100		$100		$100	
Business B income	$100		$100		$100		$100		$100	
U.S. taxable income	$200		$200		$200		$200		$200	
U.S. tax before credit	$100		$100		$100		$100		$100	
Foreign tax		0		$50		$50		$50		$50
Proposed reduction of credit limitation per section 431							($25)		($25)	
U.S. tax after credit		$100		$50		$50		$75		$75
Total U.S. & Foreign taxes on $400 net income over 3-yr. period		$200		$200		$200		$250		$225
Total Effective Tax Rate (Total tax / 3 year net income)		50%		50%		50%		62.5%		56.25%

Table No. 2, below, graphically illustrates that the so-called tax benefit recapture operates to disallow foreign tax credits and correspondingly increases the U.S. tax on foreign operations where taxpayer never had U.S. source income which could be offset against the foreign loss. As previously stated, such disallowance results in the U.S. imposition of an additional tax on foreign source income. It is again assumed that the foreign tax rates are 50 percent. As set forth in Table No. 2, a U.S. taxpayer operating in countries A and B, and experiencing a loss in country B in 1970 will, depending on whether a foreign loss carryover is or is not allowed, be subject to a total effective tax rate of 75 percent and 68.75 percent, respectively, over the 3-year period up to and including 1972. Under existing law such taxpayer would be subject to a total effective tax rate of 50 percent regardless of whether a foreign loss carryover is allowed.

Table No. 2

Effect of Proposed Section 431
Under Per Country Limitation
Where No U.S. Source Income

	Both Businesses in Foreign Countries, No U.S. Business, No Loss Carryover Allowed Under Foreign Law				Both Businesses in Foreign Countries, No U.S. Business, Loss Carryover allowed under Foreign Law			
		Foreign Tax	U.S. Tax	Total Tax		Foreign Tax	U.S. Tax	Total Tax
1970								
Business in country A	$100	$50			$100	$50		
Business in country B	($100)	0			($100)	0		
Total Foreign tax		$50				$50		
U.S. taxable income	0				0			
U.S tax before credit			0				0	
Creditable Foreign tax			$50				$50	
U.S. tax after credit			0				0	
Total U.S. & Foreign tax				$50				$50
1971								
Business in country A	$100	$50			$100	$50		
Business in country B	$100	$50			$100	0		
Total Foreign tax		$100				$50		
U.S. taxable income	$200				$200			
U.S. tax before credit			$100				$100	
Proposed reduction of credit limitation per section 431	($25)				($25)			
U.S. tax after credit			$25				$50	
Total U.S. & Foreign tax				$125				$100
1972								
Business in country A	$100	$50			$100	$50		
Business in country B	$100	$50			$100	50		
Total Foreign tax		$100				$100		
U.S. taxable income	$200				$200			
U.S. tax before credit			$100				$100	
Proposed reduction of credit limitation per section 431	($25)				($25)			
U.S. tax after credit			$25				$25	
Total U.S. & Foreign tax				$125				$125
Total U.S. & Foreign taxes on $400 net income over 3-yr. period				$300				$275
Total Effective Tax Rate (Total tax paid/total taxable income)				75%				68.75%

Even in cases where the foreign loss did not prevent the United States from receiving its full tax on U.S.-source income because of lower effective foreign tax rates in other countries, section 431 would operate to reduce foreign tax credits in later years. This is shown in Table No. 3 in which it is assumed that all countries have a 50% rate of tax, except that country A's rate is reduced to 20% in order to act as an incentive to attract needed foreign investment and Country B does not allow a loss carryover.

Table No. 3

Effect of Section 431 On Less

Developed Country Tax Incentives

	Income or (loss)	U.S. tax	Foreign tax	Actual tax rate
1970:				
U.S. business	$500	$250		50%
Business in country A	500	250	$100	20%
Business in country B	(100)	(50)	0	50%
	900	$450		
Foreign tax credit		-100		
Net U.S. tax		350		
1971:				
U.S. business	500	250		
Business in country A	500	250	100	
Business in country B	200	100	100	
	1200	600		
Foreign tax credit				
For country A tax		-100		
For country B tax		-50		
Net U.S. tax		450		
Total taxable income		$2100		
Total tax paid				
U.S.		800		
Foreign		300		
		$1100		
Total Effective Tax Rate (Total tax paid/total taxable income)			57%	

Thus, the taxpayer is penalized by a reduction in the limitation on the credit for 1971 country B taxes, and $50 of the credit otherwise allowable for those taxes is disallowed by reason of the $100 loss in that country in 1970, even though the U.S. in that year received its full tax of $250 on the U.S.-source income of $500.

It is common for many of the underdeveloped countries to attempt to attract much needed foreign investment through various tax incentive programs, which have the effect of lowering the tax rate on business operations conducted in that country by foreigners. Under present law, since the U.S. does not recognize the tax sparing principle, any benefits granted by the local tax law will not be realized by the U.S. national but will be sponged up by the U.S. Treasury. Thus, under proposed section 431, the U.S. will exact an additional tax on foreign source income (because of lost foreign tax credits otherwise allowable) even though the loss in country B did not offset U.S. tax on U.S. source income because of incentive tax reductions offered the U.S. taxpayer in his country A operations.

3. Section 432 - Separate Mineral Income Limitation

Section 432 of H.R. 13270 provides that the foreign tax credit limitation is to be separately applied with respect to foreign mineral income arising from sources within the foreign country from which the income is derived. This separate limitation is to be applied whether the taxpayer otherwise uses the per country or the overall

limitation on the foreign tax credit. The separate foreign tax credit limitation is to be imposed in the following situations:

(1) where the foreign country requires the payment of a royalty or bonus with respect to the property from which the foreign mineral income is derived;

(2) where the foreign country has substantial mineral rights with respect to property from which the foreign mineral income is derived; or

(3) where the foreign country imposes an income tax on foreign mineral income at a higher effective rate than the tax imposed by the country on other types of income.

Foreign mineral income means taxable income from mines, wells, and other natural deposits within a foreign country, but only to the extent that the income is considered "taxable income from the property" for purposes of the percentage depletion provisions of the code. Dividends received by a U.S. taxpayer from a foreign corporation with respect to which a deemed-paid foreign tax credit may be claimed are to be treated as foreign mineral income to the extent the dividend is attributable to this type of income. A partner's distributive share of the partnership's foreign mineral income also is to be considered foreign mineral income in the hands of the partner for purposes of the limitation.

House Report No. 91-413 supra, indicates that the sole reason for the separate mineral income limitation on the foreign tax credit is to isolate those cases in which it is likely that the income taxes repre-

sent, at least in part, royalties because of the difficulty in distinguishing a royalty payment from a tax payment.

The Treasury has recommended that proposed section 432 in its present form should not be adopted.

The Treasury has recommended that excess foreign tax credits resulting from the allowance of percentage depletion by the U.S. should not be available against other foreign income. This recommendation of the Treasury is based on the assumption that percentage depletion will not be denied to the mineral industry operating abroad. The Treasury has also suggested that a method of handling foreign income taxes imposed at rates in excess of the U.S. rate would be to disallow foreign tax credits to the extent of any foreign income taxed at a rate in excess of 60 percent.

Recommendation

The Council concurs with the Treasury recommendation that section 432 should not be enacted. The Council does not concur in the Treasury's alternative to section 432.

Accordingly, for the reasons set forth below the Council recommends that section 432 and the Treasury's alternative thereto not be enacted. The Council would also oppose disallowance of the foreign tax credit merely because the foreign tax was imposed at a rate greater than the U.S. rate.

Violates Principle of Tax Neutrality

In the past, the Council has opposed computing the foreign tax credit separately in respect of different types of business income. For 50 years the foreign tax credit provisions have always been applied

uniformly to taxpayers regardless of the type of business from which income is derived. As a matter of tax policy, it is wrong to depart from this basic principle by imposing a separate limitation on particular items of income or on particular industries. To discriminate against a particular type of business activity is to create a dangerous precedent which can be used against other types of business activity in the future.

Such tax discrimination has been rejected by Congress. The President's 1963 Tax Message recommended that the foreign tax credit be limited to prevent excess foreign tax credits arising from oil, gas and mineral operations abroad from being used to offset U.S. taxes on other forms or sources of foreign income. The Congress rejected this proposal.

The Council opposed the 1963 proposals, and continues to oppose the creation of a separate limitation on foreign mineral income.

Fragments Income

The present U.S. system of avoiding international double taxation is premised upon providing a credit against U.S. tax for foreign tax applicable to the foreign source income of a U.S. national. The effect of section 904 of existing law is to insure that the U.S. national is subject to tax on all foreign source income, computed on either the per country or overall basis, at the greater of the U.S. or foreign tax rate. The U.S. heretofore has not attempted to impose tax on various items of foreign business income at varying tax rates. The requirement of section 432 of H.R. 13270, along with the proposed Treasury alternative

thereto, limiting the foreign tax credit of a U.S. national deriving foreign mineral income under the prescribed circumstances to a per country and per item basis, results in fragmenting foreign income for purposes of computing the limitation on the foreign tax credit. This will further complicate the U.S. taxation of foreign income.

The principle of existing law is that all foreign source income of a taxpayer, either within a country or worldwide, is taken as a unit in assuring that the total tax burden shall not be less than the higher of the U.S. or the foreign taxes. It is wrong in principle to segregate these operations and abandon tax neutrality.

Effect On Section 904 Election

Section 432 of H.R. 13270 is contrary to the principle affirmed by Congress in 1960 when it enacted the overall limitation as an alternative limitation on the foreign tax credit. Section 432 would go a long way toward nullifying the present equitable alternative per country and overall foreign tax credit limitations by imposing a new per item limitation.

Rationale Obscure

The Council does not understand why segregating the foreign tax and royalty payments should present difficulties of a type with which the Internal Revenue Service cannot adequately cope. The Council agrees with

the statement of Assistant Secretary Cohen appearing on pages 47 and 48 of his September 11th testimony before this Committee that:

> "... we do not feel that it is proper to characterize all foreign taxes on mineral income in excess of U.S. taxes on such income as disguised royalties."

It should be stressed that, contrary to the implication set forth in House Report No. 91-413 supra, such royalty payments are by no means minimal and/or incidental. Rather, as set forth below in Table No. 4, petroleum royalty payments are substantial in relation to the tax rate of the foreign country wherein the minerals are produced.

TABLE NO. 4

Comparison of Foreign Royalty and Statutory Income Tax Rates

	Petroleum Royalty Rate	Statutory Income Tax Rate
U. S.	12 1/2% to 16 2/3%	52.8% *
Venezuela	16 2/3% to 25%	52.0%
Iran	12 1/2%	50.0%
Kuwait	12 1/2%	50.0%
Saudi Arabia	12 1/2% to 19% **	50.0%
Libya	12 1/2%	50.0%
Nigeria	12 1/2%	50.0%
Canada	12 1/2% to 16 2/3%	51.5% *
United Kingdom	12 1/2%	45%

* Includes Surtax
** A fixed amount per barrel resulting in such percentage range.

Increases Complexity

Furthermore, the complexities of the foreign tax credit provisions would be compounded were it necessary for a company to divide its operations into separate functions and then to determine the amount of foreign income tax which might be considered paid in respect of the various functions in order to compute a separate limitation on the credit for such tax. This increasing complexity will greatly increase the problems of taxpayer compliance and government tax administration.

National Policy

The separate mineral income limitation violates the long standing policy of the United States to further the economic development of less developed nations. This policy has been manifest in our foreign assistance program, as well as in the various provisions of the Internal Revenue Code which encourage investment in less developed areas. See, for example, sections 902(a)(1), 954(b), 1248(d)(3), and 4916.

Consistent with this policy, large investments by American industry have been made in less developed areas of Asia, Africa and South America. For instance, heavy direct investments in less developed countries by the natural resources industry have been a significant factor in raising the living standards of those nations where mineral wealth has been discovered. Accordingly, it would be inconsistent with such national policy to single out a particular industry for adverse tax treatment which would discourage world-wide investments which such policy is designed to promote.

Foreign Competition

The separate mineral income limitation will make U.S. companies less competitive. As a result of their predominant position in world-wide business, U.S. companies have been able to make significant contributions to the U.S. economy in general and to the U.S. balance of payments in particular. However, it must always be borne in mind that U.S. companies and citizens who venture abroad are in direct competition with large, strong, and aggressive foreign companies. Many of these foreign companies enjoy tax benefits under the laws of their countries which aid them in their foreign ventures. Moreover, some of these companies are direct agencies of foreign governments. To our knowledge, none of these foreign governments embrace, either directly or indirectly, a policy of penalizing foreign operations.

Section 904(f) No Precedent

Finally, while there is a separate limitation applying to certain interest income under section 904(f), this separate limitation for interest income in the Revenue Act of 1962 was a special measure to discourage artificial and temporary shifting of short-term investments in interest-bearing securities from the United States to foreign countries principally for the purpose of utilizing excess foreign tax credit. This provision applies only to portfolio type investment interest and was expressly made inapplicable to investments directly related to an active business of the taxpayer. Investments in foreign mineral producing properties clearly are not temporary tax-avoidance arrangements but rather represent investments in an active business and in

resources in which the United States has a vital national interest.

Treasury Proposals

As set forth above, the foreign tax credit provisions have long recognized that foreign tax laws do not, and cannot be expected to, mirror the U.S. tax law. Nevertheless, the Treasury proposes that excess foreign tax credits which result from the allowance of percentage depletion by the United States should not be available against other foreign income. The Treasury also suggested that foreign taxes imposed at some arbitrary rate in excess of the U.S. rate might be disallowed as a credit against U.S. tax.

The Treasury proposals would dilute the effect of the foreign tax credit as a means of avoiding international double taxation. These proposals would further erode the principle that foreign tax credits are computed upon the taxpayer's entire taxable income from either a particular country or worldwide, depending upon whether the per country or overall limitation is elected, as long as such foreign tax is not credited against U.S. tax attributable to U.S. source income. The fact that the foreign income tax law does not precisely mirror the Internal Revenue Code should not be significant as long as such foreign tax is an income tax, or a tax in lieu thereof. The fact that taxpayer may have been faced with a tax in excess of 60 percent (or other arbitrary percentage) should not justify the denial of such excess as a foreign tax credit against the U.S. tax on foreign source income. Such a denial is contrary to the principle of the overall limitation, which is to permit the averaging of high and low foreign tax rates.

3. Section 501 - Elimination of Percentage Depletion on Foreign Oil and Gas Production

Section 501 of H.R. 13270 would limit percentage depletion applicable to oil and gas wells to wells located in the U.S., its possessions, Puerto Rico, or on the outer continental shelf.

Recommendation

The Council recommends that this provision of section 501(a) not be enacted for the following reasons:

Violates Tax Neutrality

Section 501(a) would discriminate against foreign oil and gas production and would be contrary to the principle of tax neutrality that is the justification for United States taxing income world wide. Although a strong argument can be made for taxing only income that is earned in the United States, Congress has rejected this alternative on the theory that the income of a U.S. firm should be taxed on the same basis irrespective of where it arises. So long as that principle is followed by our country, Congress should not discriminate against income from foreign sources. Elimination of percentage depletion on foreign oil and gas production would do just that.

At present, U.S. firms producing abroad are subject to the same income tax laws as domestic producers and are entitled to the same depletion deduction allowed domestic production. This policy should be continued.

Would Reduce U.S. Tax Revenue

Although elimination of depletion on foreign production of oil and gas would result initially in residual U.S. tax, such increase would be a strong inducement for foreign governments to increase their effective tax rates. As a consequence, foreign tax payments and the foreign tax credit would be expected to increase, and no additional taxes would be paid to the U.S. The net effect would be a reduction of profits available for paying taxable dividends to U.S. stockholders in an amount equal to the additional foreign taxes collected, and eventually a reduction in U.S. tax revenue.

In some 24 countries the tax laws contain some type of percentage depletion deduction provisions. Most of these provisions are modeled after the U.S. law. Obviously, we could not expect those provisions to remain in force if the U.S. were to eliminate percentage depletion on foreign production. In at least one country there is provision for automatic nullification of the depletion deduction in the event a foreign producer loses its right to a depletion deduction in its home country. In any event, whether the increase in foreign taxes takes place under an automatic provision in the foreign tax law, or follows gradually by legislation, the result will be the same -- any appreciable increase in revenues to the U.S. will eventually disappear and be replaced by a reduction in U.S. tax revenue as a result of the lower profits available for paying taxable dividends to U.S. stockholders.

Place U.S. Companies at Competitive Disadvantage

United States petroleum companies compete with companies from other developed countries for the opportunity to develop and operate foreign fields. Many of those are strong and aggressive companies which are owned by their governments, or which, where privately owned, enjoy special tax considerations from their governments. The Soviet government engages directly in oil production and exports about one million barrels daily, adding to the competitive forces which U.S. companies must meet. Many of the Western European countries and Japan now provide tax incentives for national companies exploring overseas and this is now being considered by the European Common Market.

Companies from these developed countries are in direct competition with U.S. companies producing petroleum abroad. It is ironic that at the same time foreign governments are maintaining or increasing incentives for local companies to acquire foreign oil interests, the U.S. is considering action which would increase the tax burden of its companies engaged in foreign exploration and production.

Risks Greater Abroad Than in the U.S.

The search for oil and gas is as inherently uncertain abroad as in the U.S. Congress in adopting the depletion provision gave recognition to the particular risks in the oil and gas business both at home and abroad.

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American companies producing oil in foreign countries have added risks of losses through war, expropriation and nationalization not faced by domestic producers.

<u>Adverse Effect on Balance of Payments</u>

American companies account for 56 percent of the Free World's oil produced abroad. The operations of these companies contribute substantially toward a more favorable balance of payments. The expected increase in foreign taxes as an offset against the gain in U.S. tax from elimination of foreign depletion would have an adverse effect on our balance of payments position.

<u>Ownership of Foreign Crude Oil Reserves by Americans is Important</u>

Oil consumption in the U.S. is over a third of the Free World total, but domestic reserves are only one-tenth of the total in the Free World. American ownership of foreign oil resources is essential to assure an adequate future supply for both national security and economic strength. The absence of U.S. control of these foreign reserves will result in those who do control them turning to their own nationals rather than American companies for technical assistance, construction and operating equipment.

Foreign Oil Investments
Contribute to U.S. Goals

Investments of American oil companies abroad serve to increase U.S. trade with those foreign countries and to contribute substantially toward making them less dependent on U.S. gifts and aid.

III

Other Tax Reform Measures

1. Clarification On The U.S. Income Tax Status of The Continental Shelf

In his testimony before the Senate Finance Committee, Assistant Secretary, Edwin S. Cohen, recommended that the U.S. income tax status of the continental shelf areas of the world be clarified by amending the definition of "United States" in the Code to include the continental shelf of the United States with respect to the exploration for natural resources and defining the term "foreign country" as used in the Code to include the continental shelf which pertains to the foreign country concerned. While the Council recognizes the need for clarification of the law in this area, the Council believes that the proposal set forth is consistent with the position taken by taxpayers and the Internal Revenue Service in past administration of the U.S. income tax law. The Treasury Department recommendation is also consistent with the position of the National Petroleum Council with respect to the policy which the U.S. should

follow regarding the area of the continental shelf over which the United States should exercise jurisdiction.

In connection with the proposed definition of the term "foreign country" we think that it is important to define the term so that it includes any part of the Continental Shelf adjacent to a foreign country with respect to which that foreign country exercises jurisdiction to grant licenses or permits to conduct operations, whether or not the rule applied in determining the area with respect to which jurisdiction is to be exercised or the degree of jurisdiction to be exercised is the same as that applied by the United States with respect to the Continental Shelf adjacent to the United States. Unless such a definition is used, a taxpayer carrying on operations on the Continental Shelf of a foreign country which exercises jurisdiction with respect to that Continental Shelf might be subjected to international double taxation if the U.S. income tax definition of the term "foreign country" were not broad enough to include the area in which the taxpayer carried on operations.

Recommendation

Accordingly, the Council recommends that the tax status of the continental shelf be clarified along the lines of the Treasury proposal. However, the definition of the continental shelf adjacent to a foreign country should clearly include any portion thereof over which the foreign country exercises jurisdiction to grant licenses or permits to conduct operations.

2. Section 452 - Earnings and Profits

Section 452 of the Bill would amend section 312 of the Code, to add back to "earnings and profits" of corporations the excess of accelerated depreciation over straight-line depreciation. The stated purpose of the amendment is to obviate the payment of tax-free dividends by public utility and real estate corporations from funds derived by claiming accelerated depreciation. H. Rept. No. 91-413 (Pt. 1), 134.

Earnings and profits as defined in section 312 of the Code is relevant to other Code sections dealing with the foreign area in general and with foreign tax credits in particular. The implications of section 452 of the Bill may extend far beyond the receipt of "tax-free" dividends from regulated public utility and/or real estate corporations. It does not appear that these implications have been fully comprehended or intended by either the Ways and Means Committee or the Treasury Department.

Recommendation

Section 452 of the Bill should not be enacted. If enacted, its application should be limited to the distribution of "tax-free" dividends.

It could be provided that if a company makes a distribution which it considers is not out of earnings and profits, such company must revise its earnings and profits for a specified period of years to add back accelerated depreciation in excess of straight-line depreciation. This last suggestion

might be useful in permitting the Treasury to counter abuse situations while freeing corporations not having this situation from the voluminous record keeping requirements and unintended effects which would be involved in the present proposal.

In any event, section 452 should not apply to the determination of earnings and profits for purposes of computing foreign tax credits, minimum distributions or when such determination is otherwise required under section 964 of the Code.

Code Sections Affected by Section 452

A. Section 902

Under section 902, a domestic corporation upon receipt of a dividend from a 10 percent or more owned foreign corporation is deemed to have paid that proportion of the taxes paid or deemed to be paid by the foreign subsidiary to any foreign country or U.S. possession on or with respect to the accumulated profits out of which such dividends were paid.

Enactment of section 452 in its present form, which would add back to earnings the excess of accelerated depreciation over straight-line depreciation, would have the effect of increasing the earnings of foreign subsidiaries for purposes of calculating the deemed paid tax credit under section 902 of the Code, thereby de-

decreasing the allowable foreign tax credit. Such procedure would be contrary to the trend of industrialized nations to permit some form of accelerated depreciation in reducing taxes otherwise payable to their Government. Increasing the earnings of foreign subsidiaries in this manner if this is intended would dilute the foreign tax credits allowable against income received from such subsidiaries and in effect denies to these foreign corporations the benefits of reduced tax cost provided by the foreign country.

B. Section 963

Enactment of section 452 of the Bill could alter the computation of the required minimum distributions under section 963 of the Code. Section 963 is a relief provision added to the Revenue Act of 1962 by this Committee which attempts to ameliorate the harsh results of the provisions of subpart F. Under section 963, if a domestic corporation elects to receive a "minimum distribution" it is not required to include in its gross income its share of subpart F income. Broadly speaking where the effective foreign tax rate is less than 90 percent of the U.S. rate, a minimum distribution, stated in terms of the foreign corporation's earnings and profits, will be required in order to avoid subpart F treatment.

Section 452 of the Bill might increase the earnings and profits of a controlled foreign corporation, and decrease the effective foreign tax rate and thus increase the required minimum distribution and could be inconsistent with the relief intended by Congress in 1962.

C. <u>Other Sections</u>

Section 960 of the Code provides for a foreign tax credit with respect to the inclusion of subpart F income in the gross income of a shareholder in a controlled foreign corporation. Enactment of section 452 of the Bill could present problems under section 960 which are similar to those discussed above under section 902.

Section 956 of the Code provides that any increase for a taxable year in the earnings of a controlled foreign corporation invested in U.S. property must be included in the gross income of a U.S. shareholder in a controlled foreign corporation to the extent such amount would have constituted a dividend if it had been distributed. The determination of such amount could require a computation of the earnings and profits of the controlled foreign corporation and as such could be affected by the enactment of the section 452 of the Bill.

Section 959 prescribes ordering rules with respect to the allocation of distributions from controlled foreign corporations which in turn are related to earnings and profits concepts which could be affected by the enactment of section 452.

Since section 1248 provides that gain recognized upon the sale or exchange of stock in a controlled corporation shall be treated as a dividend attributable to such stock under prescribed circumstances, this section may be affected by section 452 of the Bill.

3. Liberalization of Indirect Credit

In view of the growing demand for local participation and the necessity to participate in consortiums through foreign subsidiaries at various levels, the Council considers that it is now the appropriate time to broaden the relief afforded by Section 902 by extending the indirect credit beyond the second tier. There should be no administrative problems in extending the benefits of Section 902 beyond the second tier since the acquisition of as little as a 5 percent direct or indirect interest must be reported to the Internal Revenue Service together with current financial information. The Internal Revenue Service must review these documents in the course of any audit of a U.S. corporation with an interest in foreign subsidiaries. In addition, the domestic corporation has the ultimate burden of substantiating any foreign tax credits claimed.

Recommendation

The indirect credit should be extended to apply with respect to dividends received from any foreign corporation, irrespective of the number of tiers of ownership, provided the domestic parent has an overall stock ownership of 5 percent in the chain of foreign corporations through which the dividend is distributed.

4. Section 367

Section 367 of the Internal Revenue Code of 1954, first enacted in 1932, provides that unless the taxpayer obtains an advance ruling from the

Commissioner that tax avoidance is not a principle purpose of certain types of transactions involving the organisation, reorganisation or liquidation of a foreign corporation, such foreign corporation will not be treated as a corporation. Where such advance clearance is not obtained, any gain, which would otherwise not be recognised under the provisions of subchapter C of the Code, had domestic corporations been involved, will be recognised. It therefore becomes essential for the taxpayer to obtain an advance Section 367 clearance from the Commissioner whenever the types of transactions set forth above are contemplated. See Rev. Proc. 68-23, IRB 1968-22,33.

Under Rev. Proc. 68-23, Section 367 is being administered in an arbitrary manner to exact costly "toll gate" charges from taxpayers as the price of obtaining the favorable ruling essential to the consummation of an otherwise bona fide business transaction. In addition, the present advance ruling procedure is fraught with costly delays for taxpayers even where the toll gate charge is to be exacted.

More importantly, transactions described in Section 367 occurring between foreign affiliates are often consummated without the knowledge of the U.S. parent so that an advance ruling is not obtained. In such cases, a tax must be paid with no recourse to judicial review, even in cases where it is obvious that tax avoidance is clearly not present and where an advance clearance would have been granted as a matter of eventual routine on the part of the Commissioner.

(1) In view of the present information reporting requirements and the array of other code sections and judicial precedent upon which the Commissioner can now rely in preventing tax avoidance, the Council recommends the repeal of Section 367.

(2) At the very least, Section 367 should be amended retroactively to all open years, to eliminate the advance ruling requirement. This would be consistent with the tax treatment now afforded the realignment of domestic corporations. Thus, the facts of any given transaction as finally developed would be determinative of the tax treatment afforded such transaction. Consistent with other areas of the tax law, this recommended change would restore to taxpayers that fundamental right of having legitimate differences as to taxpayer's motive resolved by the court rather than by the Commissioner, who by statute, now sits as appellate judge and jury in Section 367 cases.

5. Section 231 Moving Expenses

Section 231 of the Bill provides for the deduction of additional categories of moving expenses subject to an overall limitation of $2500.

The Council agrees in principle with the liberalization of deductions for moving expenses. However, a dollar limitation on indirect expenses to protect against abuses will act unfairly in cases where expenses are reasonable in amount but exceed the limitation. Moreover, because of possible inflation, a reasonable dollar limit today might be

completely inadequate in the future. If a dollar limitation is to be provided, it should be applied only to moves within the United States. Moving expenses in respect of overseas assignments generally involve more indirect expenses and can vary greatly as between countries. Where the move is requested by the employer and the expenses are the employer's, an attempt to tax the employee will only result in additional costs to be borne by the employer.

Recommendation

Accordingly, if a limitation will be placed on the amount of moving expense which will be allowed as a deduction, the Council recommends that such limitation should not be below $2500 in the case of transfers within the U.S. However, such limitation should have no application in respect of moving expenses incurred in respect of overseas assignments where the amounts involved vary so greatly that it would be quite inequitable to restrict the deduction to a specified amount.

On taking an overseas assignment many people sell their U.S. home but do not purchase a home in the foreign country because of exchange risks, and the like. The Council therefore recommends that the 1-year period to purchase a new home under section 1034(a) not commence to run in such case until the employee returns to, and takes up residence in, the U.S.

6. Section 444 Foreign Deposits in U.S. Banks

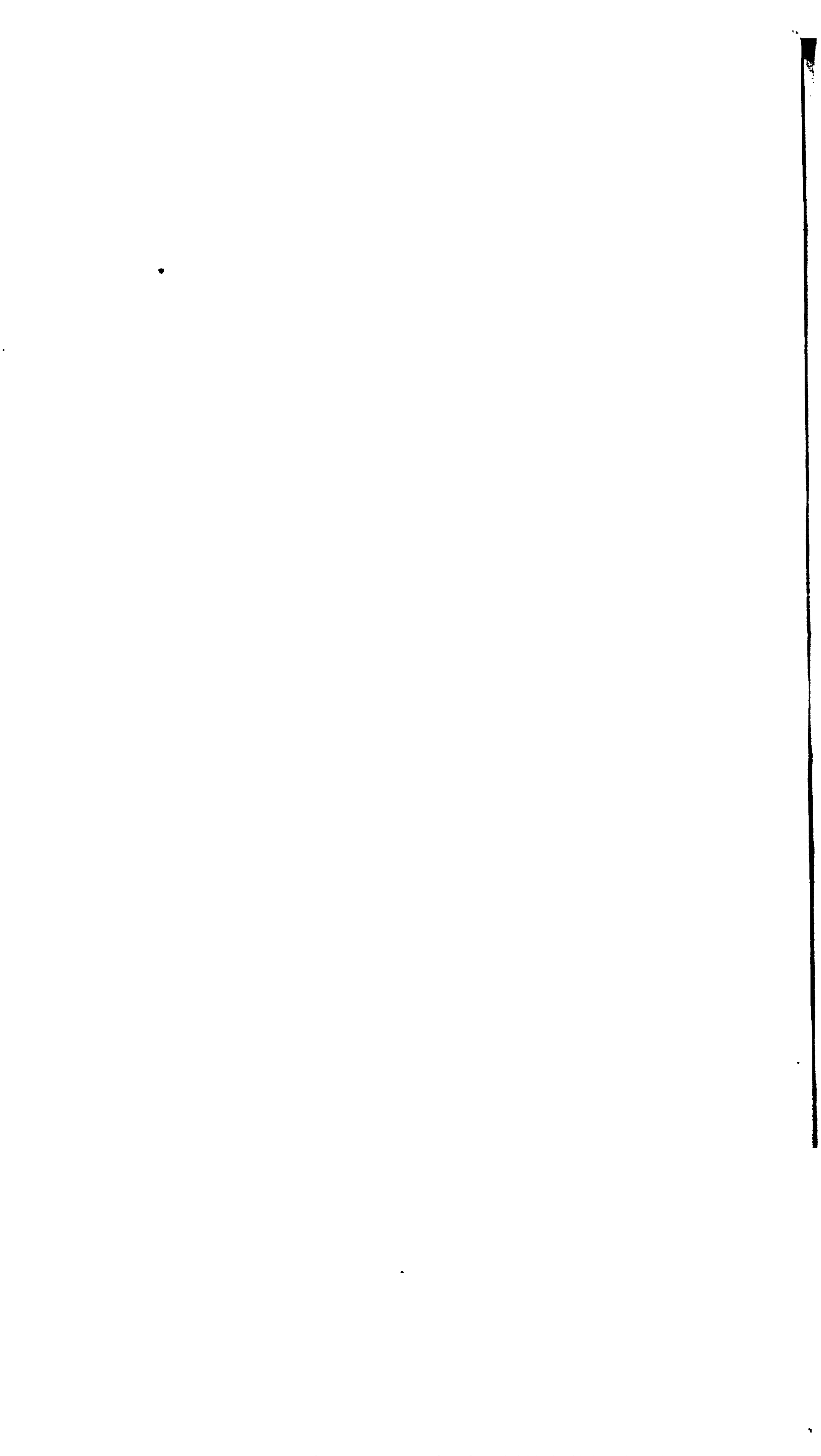
In April of this year President Nixon indicated that his Administration will review existing regulations and tax policy to assure that foreign

investment in the U.S. is not discouraged. By way of specific example, the President stated that we should move now to eliminate from our laws the prospective taxation of interest on foreign held U.S. bank deposits. In this connection, President Nixon proposed the immediate repeal of the portion of section 861 of the Internal Revenue Code which would tax the interest paid to foreign depositors after December 31, 1972 in respect of U.S. bank deposits unrelated to a trade or business. It was similarly proposed to retain the present exemption of such deposits from estate tax.

Section 444 of the House Bill does not implement the President's proposals but merely defers the U.S. income and estate taxation to 1976. As recognized by the Administration and by every major commercial body which has expressed itself on these subjects since introduced through the Foreign Investors Tax Act, the provisions of present law tend to discourage the investment of funds in the United States and places a direct drain on the U.S. balance of payments.

Recommendation

The Council recommends that President Nixon's proposals be supported by the immediate and complete removal of the expiration date of the relief provisions found in present law.



United States Council of the International Chamber of Commerce Inc

1212 Avenue of the Americas New York NY 10036 JU 2-4850

United States Council

SUMMARY OF PRINCIPAL POINTS
IN THE

STATEMENT OF WILLIAM J. NOLAN, JR.
CHAIRMAN OF THE COMMITTEE ON TAXATION
OF THE UNITED STATES COUNCIL OF THE
INTERNATIONAL CHAMBER OF COMMERCE
BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

OCTOBER 3, 1969

1. The U.S. Council believes that there should be a full scale review of what the tax policy of the United States should be with regard to international activities of U.S. corporations. The great expansion of international investment since the end of World War II compels this review.

2. The U.S. Council believes that taxation of income should be based on the premise that the jurisdiction where the income is produced has the exclusive right of taxation.

3. Pending that reexamination of policy and in light of the Treasury's announcement that it will be making recommendations to Congress on "comprehensive proposals relating to the U.S. taxation of foreign source income," the U.S. Council urges that at this time there be deferred any legislation in the foreign tax area.

4. The proposals contained in Sections 431 and 432 of H.R. 13270 (and the Treasury recommendations for their revision) are injurious to foreign business and will hamper the development of foreign resources by U.S. nationals to the long-run detriment of the U.S. economy.

5. The U.S. Council strongly protests against the singling out of a particular industry for restrictive tax legislation with respect to its foreign income. We do not believe that if foreign income is to be taxed by the United States, it should be treated, for purposes of depletion or otherwise, differently than similar domestic income.

6. If the Committee on Finance decides to propose legislation affecting foreign source income, the U.S. Council urges for consideration legislation in the following additional areas:

   (a) An extension of the deemed foreign tax credit to "third tier" foreign corporations;

   (b) A broadened definition of what foreign taxes may be creditable where a foreign jurisdiction does not rely to the same extent as the United States on an income tax as the major source of tax revenue;

   (c) Restraint by the United States in taxing foreign income where the foreign jurisdiction has authorized exemption from tax or reduced the tax liability in order to encourage foreign investment - in other words, a recognition of "tax sparing";

   (d) An adjustment in the foreign tax credit computation to prevent distortions in the case of abnormal losses;

   (e) The elimination of the advance ruling requirements under Section 367 of the Internal Revenue Code for transactions involving foreign corporations;

   (f) A tolling of the one-year period under Section 1034 of the Code (relating to the deferral of the taxation of gain because of the reinvestment of proceeds from the sale of the taxpayer's principal residence) while the taxpayer is resident abroad on assignment by his employer.

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STATEMENT OF WILLIAM J. NOLAN, JR.
CHAIRMAN OF THE COMMITTEE ON TAXATION
OF THE UNITED STATES COUNCIL OF THE
INTERNATIONAL CHAMBER OF COMMERCE
BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

OCTOBER 3, 1969

My name is William J. Nolan, Jr., and I am appearing today as Chairman of the Committee on Taxation of the United States Council of the International Chamber of Commerce. The U.S. Council represents American business interests within the International Chamber, which in turn represents the international business community in some 75 countries. As some of you may recall, our Committee on Taxation has had the privilege of presenting its views on tax matters to the Committees of the Congress on many occasions.

Our Committee has had a series of meetings and has discussed at length the revision of the Internal Revenue Code proposed to be made by Sections 431 and 432 of H.R. 13270. We do have some specific things

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to say about these proposals which I will turn to very shortly. But first I would like to say that we feel strongly that the proposed changes raise policy issues concerning what the Government's basic approach to the international activities of U.S. companies ought to be. In examining the proposals, we found ourselves continually returning to the question of whether the effect would be to carry our tax policy in a direction generally consonant with the new and rapidly growing importance of our international investment and production.

Inevitably specific proposals take the form of patchwork on an already heavily patched tax instrument. This is inevitable in the amendment process as experience with given taxes indicates the need for change, but at some point we are inhibited by a sense of diminishing returns and find ourselves faced with the impossible task of trying to create a new approach by modifying an old one.

My Committee's most significant reaction to the proposed changes, is, then, that they are modifications in a foreign tax program which itself is in serious need of reappraisal. In this connection we are most pleased that in his statement before this Committee on September 4, Assistant Secretary Cohen has indicated that an over-all review of foreign tax policy is being made by the Treasury. It goes without saying that the Council's Committee would like to make its experience and expertise available in any way that it is felt would be helpful in this constructive review.

The present system of foreign tax offset in its very nature implies the continued exercise of primary tax jurisdiction by the country where production takes place. This prior right has long been recognized in U. S. tax policy on the grounds that it is the host country that provides the infrastructural services and the political and social framework. But under the present system the ultimate and perhaps the crucially important tax jurisdiction is exercised by the parent company's country. In the typical instance this means that this latter country decides such important issues as the desirable level of total taxation. This decision clearly has a very important bearing on the competitive position of our producing activities abroad. Furthermore, the parent company's country, in exercising these important responsibilities, is motivated by considerations that almost certainly are tangential to the question of the growth and competitive strength of these activities. The present approach to the taxation of our foreign-based business treats the income very much like a windfall profit unaffected by the character of the tax, whether or not the effect of the policy is detrimental to the growth of such income. It should be noted in contrast that this last consideration -- the integrity and growth of income -- is the key consideration in our domestic tax philosophy.

In the pre-World War II period international production tended to be so limited that its relevance to national economic policy was small. But

since the Second World War there has been an enormous growth of international production -- 10% a year on the average since 1950 for a five-fold increase. This is an expansion far more rapid than the 4 and 5 percent GNP rates familiar in national growth, as fast even as the so-called "miracle" growth rates reached in some year in Germany, Italy, and Japan.

In fact foreign business activity is no longer merely a peripheral activity of American business, nor one raising only incidental problems of taxation. In our close following of the trends of internationalized production at the U.S. Council we now work with a figure of estimated U.S. production abroad of $200 billion, and foreign production in this country estimated at $90 billion. Just to emphasize the order of magnitude here, we are talking about goods and services that compare with the size of the Japanese and German economies combined.

Internationalized production is clearly and by far the most important link between this country and world markets and is the principal means through which we exert an upward influence on world income. It has only started to be recognized that these producing activities are five times more important than exports as a means by which we reach foreign markets Looking ahead a little, it is clear from the vigor of international

enterprise that somewhat more than half the production of the world will be internationalized in the next 25 years or so.

Internationalized production has been brought to its present impressive importance through international investment that has taken place since the end of World War II. The United States has taken the lead in these trends, which clearly have had a transforming influence on the structure and productivity of world economic activity.

U.S participation in international production typically involves a melding of U.S. capital and management with the management, capital, resources and labor of the foreign country, with foreign imputs ordinarily far in excess of U.S. ones. The result of this melding of productive contributions has been a better international allocation of resources, a dynamic growth of production worldwide, and a glimpse of the beginnings of a world economy. Fundamental tax policy questions that could be reasonably put off at earlier stages of growth must now be faced directly, because tax policy directly affects the productivity of resources.

With this in mind it is our belief, and that of the worldwide International Chamber of Commerce, that tax jurisdiction ought to be exclusively in the hands of the authorities that prevail where the production is taking place. The present system under which the U.S asserts ultimate

jurisdiction over income earned abroad by American companies is subject to at least two sweeping objections. It disregards the effect of taxation on desirable allocation of resources from a production standpoint and, beyond this, it is almost unmanageably complex.

In the long run United States tax revenues are bound to increase even though confined to income produced within its geographic jurisdiction. This is a necessary consequence of the higher production resulting from a better international allocation of resources, through which process U.S. resources are more efficiently utilized in adaptation to the broader world market. The American experience in the last decade seems to be a dramatic confirmation of the advantages in terms of production that accrue to this country as it has in fact geared its production to a worldwide basis. No one who has studied the experience of the growing number of the country's international companies would question the dramatic upward thrust that "going international" has imparted to domestic as well as overall operations. A company with coordinated producing bases distributed throughout world markets increases not only its total production but also the productivity of each of the bases. These advantages appear in the realistic form of lower costs and higher yields -- one might add, higher taxable yields. International differentials in after-tax income should be accepted as being the primary guides to the flow of resources into their

most productive uses in exactly the same way that after-tax differentials within the domestic jurisdiction operate.

In preparing our specific comments we have tried as far as possible to apply these international perspectives which we believe should underlie the taxation of international production now and in the future. At the same time we recognize in our review that the questions at hand would not actually arise if the United States were operating under the basic policy here recommended, namely that tax authority be exercised only with respect to income produced within the national borders of the sovereign authority. Pending this move nations imposing taxes on income earned outside their jurisdiction should seek to minimize any negative effect on the competitive strength of these producing activities abroad and in general should weigh questions of tax policy with explicit, deliberate regard for its international implications.

We question the need for, or the desirability of, making changes at this time in the specific areas encompassed by the proposals contained in Section 431 and 432 of the Tax Reform Bill when the Treasury Department has underway the development of "comprehensive proposals relating to the U. S. taxation of foreign source income" which it has announced it will present to Congress. Our Committee suggests that further patchwork in the area of the taxation of foreign income is inadvisable and may even be

pointless when viewed in the light of the decisions which will flow from the Treasury's comprehensive recommendations.

However, if this Committee determines that there is need to legislate in the foreign tax area at this time, we desire to put before it our views as to the inadvisability of the adoption of the provisions presently incorporated in the House bill at Section 431 and 432 and the suggestion as to other items which should be considered for action.

Section 431- Per-Country Limitation

Section 431 of H. R. 13270 provides that where a taxpayer has elected the per-country limitation for foreign tax credit computations, he must carry forward losses incurred in a foreign country and use them to reduce income from that country in subsequent years before computing the limitation of the foreign tax credit to be allowed for income taxes paid to such country. The theory for this unusual proposal as expressed in the House Ways and Means Committee Report is that under present law the taxpayer receives a double tax benefit under such circumstances.

We believe that the Ways and Means Committee was mistaken in its view that a double tax benefit exists. That view must have been premised on the belief that foreign countries ordinarily do not allow loss carrybacks or carryforwards for purposes of computing income taxes. That is plainly erroneous for many countries allow losses to be offset against future income. Moreover, the taxpayer certainly receives no

double tax benefit even if the foreign host country does not allow losses to be carried back or forward. He is paying full taxes and under the theory of Section 431 he would be additionally penalized - for there would be a doubling up on his aggregate tax bill.

The Treasury's proposal that the provisions of Section 431 be expanded so as to be applicable to a taxpayer on the overall limitation who has an overall foreign loss could well result in double taxation. First, taxes paid on income in Country A would not be creditable where losses in Country B offset that income. This is the case under present law. Then, under the loss reception rule of Section 431 when the operation in Country B became profitable, foreign taxes otherwise creditable will be reduced.

Section 432 - Separate Limitation for Mineral Income

Section 432 of the House bill (which the Treasury has recommended to this Committee be substantially altered) would apply a separate limitation on the foreign tax credit with respect to foreign taxes attributable to foreign mineral income. The theory underlying the limitation, as expressed in the report of the Ways and Means Committee, is to isolate cases where "income taxes represent, at least in part, royalties." The three tests are whether the foreign country:

(1) requires payment of a bonus or royalty,

(2) holds substantial mineral rights with respect to the property, or

(3) imposes any income taxes on mineral income at an effective rate higher than on other income.

We do not believe that the above three tests represent a valid basis for a conclusive statutory presumption that certain income taxes actually represent royalties. The fact that a royalty is paid to a foreign government is a strange basis for holding that income taxes paid to that government also contain a royalty element. But even assuming the validity of the tests, we question the desirability of fragmenting foreign income for the purpose of computing the foreign tax credit limitations.

We do not believe that it is proper tax policy to impose a separate limitation on certain items of income or on particular industries and thereby discriminate against a business activity.

Not only is a separate mineral income limitation discriminatory but it runs contrary to United States policy aimed at furthering the economic and social development of the less developed countries of the world. Further, such discrimination will undoubtedly favor foreign competition over United States interests in the very necessary efforts being made to assure our domestic economy of an adequate supply of basic minerals.

The Treasury has recognized before this Committee the discriminatory aspects of Section 432 of the House bill in treating mineral companies in a different fashion from all other U.S. taxpayers with foreign operations. The recommendation of the Treasury that, in lieu of the complex and unfair provisions of 432, there be substituted a provision denying the averaging of foreign tax credits where excess credits from one country arise out of the allowance for percentage depletion. While my Committee feels that the Treasury proposal is far better than the House provision, nevertheless we view that restriction as being contrary to the often proclaimed theory of tax neutrality as between United States investments and foreign investments.

The Treasury proposal would clearly discriminate against foreign mining opportunities.

That Treasury proposal is substantially similar to one presented to Congress in 1963 and rejected. The U.S. Council does not endorse the proposition that foreign source income should be penalized. For this reason, among others, my Committee opposes the provision of Section 501 of the House bill which would deny percentage depletion to income from certain foreign oil and gas wells. The U.S. Council is pleased to note that the Treasury also felt this discrimination to be unfair. Different rates for depletion on domestic income and foreign income are by nature an unfair discrimination.

For reasons fully explained earlier, the U.S. Council strongly urges that revisions in the area of taxation of foreign source income be deferred until the Treasury has presented its recommendations based upon its current full scale study. Otherwise changes made now may prove to have been unwise on an overall review of taxation and, even worse, will lead to additional complexities under an already complex system for the tax treatment of foreign source income.

Other Areas Involving Taxation of Foreign Income Recommended For Legislation

If the Committee on Finance concludes that legislation is desirable at this time in the area of the taxation of foreign income, then the U.S. Council desires to recommend for consideration certain additional matters which we feel are deserving of prompt legislative attention and action.

Third Tier Foreign Corporation

The U.S. Council urges that there be a broadening of the limitations of Section 902 so as to extend the foreign tax credit under certain circumstances to a third tier foreign corporation. In the last few years several bills have been introduced to accomplish this purpose. Under the present statutory provision, credit for taxes paid by a foreign corporation can only be had if (a) at least 10% of the stock of the first tier corporation is owned

by the U. S. taxpayer and (b) in the case of a subsidiary of such first tier corporation, at least 50% of the stock of the subsidiary is owned by the first tier corporation.

In the past, there apparently has been some feeling on the part of Treasury that the extension to a third tier foreign corporation made the auditing problem too great. This cannot now be a valid objection. First, with the additional reporting requirements adopted over the past several years, there is ample information available to the Internal Revenue Service to check out thoroughly any claims for foreign tax credit. And second but most important, a credit is not available unless proved. If the taxpayer is not in a position to support his claim, then he has no credit!

In some foreign jurisdictions an alien may not hold more than a minority interest. Recent developments have clearly indicated a determination on the part of foreign governments that they or their nationals must own a majority stock interest in corporations engaged in business in their jurisdictions. A maintenance of the ownership formula under Section 902 at 10% by the U. S. corporation in the first tier foreign corporation but a change to a 25% interest (now 50%) by that first tier foreign corporation in the second tier foreign corporation and the extension of the benefits of a credit to dividends received from a third tier foreign corporation owned at least 25% by the second tier foreign corporation would greatly help U. S.

business in organizing its affairs in foreign lands. In addition, it is our thought that such revision of the statute could lead to a broadening of foreign participation in those operations.

In addition to the above, the U.S. Council recommends a change in the statute to allow a foreign tax credit where related parties - say U.S. parent and U.S. subsidiary - own between them the requisite percentage ownership of a foreign corporation although neither one holds 10% in its own name. Obviously, the information on verification of any credit claims is just as available in this situation as it would be if either one of the U.S. corporations owned the 10% directly.

It is our belief that these changes would not cause any loss of revenue but would very dramatically ease the problems of foreign corporate organization for overseas operations of U S. corporations.

Broaden Definition of "Tax" For Which Credit is Given

Section 903 now permits a credit for any foreign tax paid "in lieu of a tax on income." Although this provision was intended to be broad in scope when included in the 1942 Revenue Act, the Treasury regulations and administrative practise have so restricted it that an "in lieu tax" can only be creditable if (a) the foreign country has an income tax in force, (b) the taxpayer would be subject to such income tax absent some special provision and (c) he pays a substituted tax "in lieu" thereof.

This type of restriction permits no credit for taxes imposed by a foreign country which has not adopted the income concept of taxation even though such taxes are at least as burdensome as would be an income tax. The failure to grant a credit in this situation certainly does not further tax neutrality as between foreign and domestic income.

The U.S. Council recommends to your Committee that some form of credit be adopted in respect of a country's principal tax even though it is not an income tax. Under our concept of taxation - such a tax would clearly be in lieu of an income tax. The Treasury Department itself in 1954 recommended a broadening of the "in lieu" provision along this line and we hope its current study will bring similar recommendations for corrective legislation.

Tax Sparing

The U.S. Council urges this Committee to reexamine the concept of "tax sparing." Much has been said of the irritation of less developed countries in attempting to induce investment by some form of tax benefit only to see such benefit gobbled up by the U.S. Treasury. If the foreign land - and let us assume we are only talking about less developed countries - wants to encourage investment by forgiving taxes, then why not recognize tax sparing? The other side of the coin is that without tax sparing or some equivalent restraint in taxation of foreign income, the foreign jurisdications

are faced with pushing their tax rates up to the U. S. level. Has anything been gained by them or by the United States in that type of action? Have we helped to develop the foreign country's economy? Moreover, if the United States does not recognize the concept of tax sparing, it is then penalizing its nationals in foreign operations against those of other countries with more realistic bents. One of the evils of Section 432 of the House bill is that it further encourages foreign countries to increase their tax rates and to do away with their own tax incentives. If the United States is going to nullify, through its tax system, such advantages, the foreign jurisdictions will be quick to cancel out benefits being offered for U. S. investments.

Effect of Worthless Securities Loss Upon Foreign Tax Credit Limitation

Losses from the worthlessness of foreign stocks and securities (Section 165(g), IRC) during the taxable year affect the limitation of the allowable foreign tax credit in an arbitrary and capricious way to the disadvantage of many taxpayers. It is proposed that such losses be deemed to have a U. S. source in computing the limitation on allowable foreign tax credit (Section 904, IRC).

For example, assume that the foreign source income taxable to a corporate taxpayer in a year is $1,000,000 and assume that foreign income taxes paid and "deemed paid" on this income in various foreign countries aggregate $500,000 and the taxpayer has elected the "overall" limitation.

Further assume that the U. S. tax rate is 50% so that the gross U. S. tax before foreign tax credit is $500,000 against which may be credited the $500,000 foreign income taxes paid and deemed paid. No U. S. tax is therefore payable on the taxpayer's foreign source income because the income has borne foreign income taxes at an effective overall rate equal to the U. S. rate.

Now let us assume that in a particular year the assets of a wholly-owned foreign subsidiary of the U. S. corporation are destroyed in an insurrection, and the taxpayer experiences a loss from the worthlessness of the stock of this foreign subsidiary which stock has a cost or other U. S. tax basis of $1,000,000. The loss reduces the U. S. corporate taxpayer's taxable income in the amount of $1,000,000. Under the present position of the Internal Revenue Service, however, the loss is deemed to be from a foreign source and thus reduces the numerator of the fraction limiting allowable foreign tax credits. In our example, the $500,000 of foreign income taxes paid is not creditable against U. S. income taxes in the year of loss and, if the taxpayer incurs foreign taxes at rates comparable to the U. S. rate in the two years available for "excess" foreign tax credit carry-back and in the five years open to carryover, the $500,000 will never be allowed as a credit against U. S. taxes. The result is that in the year of worthlessness the taxpayer's overall income from operating abroad is

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zero (i.e. $1,000,000 less $1,000,000 loss from the worthlessness of stock), yet the taxpayer has paid $500,000 of foreign income tax which will never be allowable as a credit against U.S. taxes.

It is submitted that the proper result would be to consider the loss on the worthlessness of the stock or securities to be from U.S. source, thereby not decreasing the numerator of the foreign tax credit limiting fraction and allowing credit for the foreign tax paid or deemed paid in our example.

A loss on worthless stock or securities in a foreign corporation may be an infrequent item, but of severe consequence. For example, if a foreign subsidiary becomes worthless because of expropriation, insurrection, natural disaster, or simply because of business failure, the loss in the year of worthlessness may be sizeable. The Internal Revenue Code recognizes this loss and allows a deduction (either capital or ordinary, Section 165(g), IRC). However, this deduction can be negated, as in our example, by denying the credit for foreign taxes paid in a manner we are confident was not contemplated by the Congress. We submit that it should be the aim of Congress to encourage investments abroad through full tax recognition of loss on the failure of such an investment. (Such losses are often in the developing countries where risk of loss is the greatest and where there have been frequent indications of Congressional intent to encourage investment.)

We believe the proposed change is particularly appropriate at this time because regulations of the Office of Foreign Direct Investment may require repatriations of income carrying foreign tax credits which would be limited by such losses. These regulations narrow any opportunity of the U.S. taxpayer to minimize the loss of foreign tax credit by suspending the payment of dividends in the year of loss, and this, in turn, has the effect of increasing the severity of the loss from a U.S. tax point of view without justification. Even if the Foreign Direct Investment Regulations are ultimately suspended, it would be in the best interest of the U.S. balance of payments to adopt the proposed change in computing the foreign tax credit limitation so as not to discourage repatriation of dividends from foreign sources.

Advance Section 367 Rulings

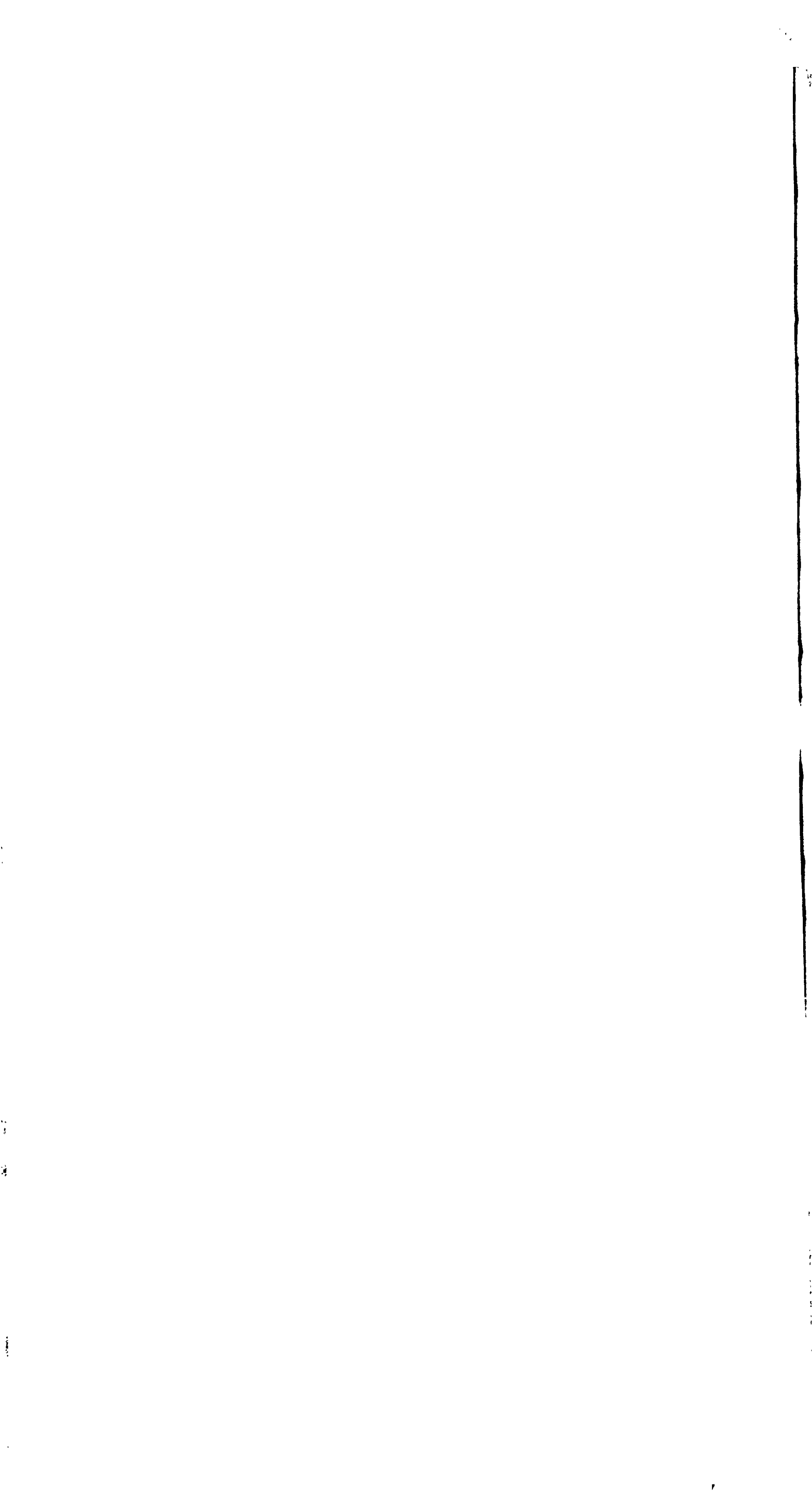
My Committee urges that there be some modification in the require ment that a ruling under Section 367 of the Internal Revenue Code must be secured in advance of the transaction involving foreign corporations if the non-recognition of gain provisions of the Code are to apply to such transaction. We suggest that if the particular transaction involving foreign corporations is determined on audit to meet those non-recognition provisions, then the fact that an advance ruling had not been secured should be immaterial to the tax treatment.

The kinds of tax abuse that Section 367 was intended to counter when enacted in 1932 are no longer present. Moreover, the Internal Revenue Service has used the advance ruling requirement as a club to force its views in areas where there exists considerable doubt. The time lag now faced by taxpayers in securing a ruling would also be avoided with the elimination of the "in advance" requirement. There is also the very real problem of a U. S. taxpayer even knowing about a transaction involving a foreign corporation in advance of its consummation much less in time to attempt to see that a ruling is requested. For these reasons we recommend the elimination of the "in advance" ruling requirement of Section 367 where it can be shown that avoidance of United States income tax was not one of the principal purposes of a particular transaction involving foreign corporations.

Nonrecognition of Gain on Sale of Residence

Under Section 1034 of the Internal Revenue Code a taxpayer who sells his principal residence at a gain will not be taxed currently on that gain if the proceeds of sale are reinvested within one year in the purchase of a new residence. My Committee would like to suggest that there be a suspension of the running of the one-year period of reinvestment in the case of any employee who has made the sale of his residence because of an assignment abroad by his employer. The suspension

period would cover the period of residence abroad. To protect the revenue the sale could be treated as taxable in the year of sale with the right of the taxpayer to claim a refund if, on his return to the United States, he fulfilled the requirements of Section 1034.



UNITED STATES SENATE
COMMITTEE ON FINANCES

SUMMARY OF
WRITTEN STATEMENT OF
JOHN A. PERKINS, PRESIDENT
WILMINGTON MEDICAL CENTER
WILMINGTON, DELAWARE 19899
IN OPPOSITION TO CERTAIN
PROVISIONS OF H.R. 13270,
TAX REFORM BILL OF 1969
SCHEDULED APPEARANCE-OCTOBER 3, 1969

I. INTRODUCTION - Description of Wilmington Medical Center and its financial needs, present and future.

II. OPPOSITION TO TAX ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS

A. Not opposed to sanctions to prevent past abuses.
B. Tax on investment income goes too far; same as tax on charities.
C. Tax on investment income may increase costs of government.
D. Support Private Foundations have given Wilmington Medical Center.
E. Support Private Foundations have given to other hospitals in the area.
F. Use of Private Foundations as land bank.

III. OPPOSITION TO TAXES ON FAILURE TO DISTRIBUTE INCOME.

IV. OPPOSITION TO TREATMENT OF CHARITABLE CONTRIBUTIONS OF APPRECIATED PROPERTY.

V. OPPOSITION TO OTHER PROVISIONS AFFECTING CHARITABLE CONTRIBUTIONS.

VI. CONCLUSION - Congress should adopt legislation which encourages rather than discourages charitable contributions.

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COMMITTEE ON FINANCE

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I. INTRODUCTION

Wilmington Medical Center, Wilmington, Delaware, is a non-profit, charitable corporation which operates three short-term acute hospital facilities and one long-term rehabilitation hospital. These facilities provide approximately 80 percent of the total hospital service for New Castle County, Delaware, and approximately 60 percent of the total hospital services for the State of Delaware.

As can be seen from an article appearing on Page 1 of the Wilmington Morning News of September 24, 1969 (Exhibit "A" attached hereto) any public or private action which might inhibit or otherwise reduce contributions to the Wilmington Medical Center will directly affect the quality and quantity of hospital services which Wilmington Medical Center can render to the community it serves. Further, since the Wilmington Medical Center, within the next ten years, must obtain and expend $80,000,000.00 to $90,000,000.00 in capital expenditures ($35,000,000.00 of which is needed by 1972 for new construction) in order to continue to provide the present quantity and quality of hospital

services for the community it serves (which presently is 500,000 and by 1980 should be 700,000), its Trustees feel that it must express opposition to those provisions of H.R. 13270, Tax Reform Bill of 1969, which might tend to prevent the Wilmington Medical Center from meeting the demands for hospital services thrust upon it by the community.

II. OPPOSITION TO SECTION 101(a) OF H.R. 13270, TAX ON INVESTMENT INCOME OF PRIVATE FOUNDATIONS.

Section 101(a) of H.R. 13270 provides that the net investment income of a "Private Foundation" shall be subject annually to a tax of 7 1/2 percent thereof.

In H.R. Rep. No. 91-413 (Part 1) 91st Cong., 1st Sess. 19 (1969), the general reason stated for proposing such tax is that the benefits of government are available to all and, thus, "the costs thereof should be borne at least to some extent by all of those able to pay." Then said report goes on to state that this is true for "Private Foundations."

Certainly, the Wilmington Medical Center would not argue that there have not been any abuses in the Private Foundation area which clearly need to be corrected by sanctions prohibiting such abuses in the future. However, Wilmington Medical Center does feel that a tax on investment income goes beyond what is a justified sanction for the abuses engaged in by a limited number of Private Foundations.

It is Wilmington Medical Center's understanding that, in part, the philosophy behind the adoption of a law permitting a deduction for

Federal income tax purposes of contributions to "charitable organizations" (including in such favored treatment "Private Foundations") was to reduce the costs of government by providing an incentive for that portion of the general public with resources to do so to fund activities which would otherwise have to be undertaken by governmental bodies. It was assumed that if the government were to undertake these activities, the cost would be greater than the revenue dollars lost by granting such a deduction. To tax the investment income earned by Private Foundations does nothing more than take away in part the ability to reduce costs of government.

Wilmington Medical Center's primary concern with respect to the proposal to tax net investment income of "Private Foundations" is that such a tax is an indirect tax on certain portions of the income of eleemosynary institutions, such as hospitals, universities and other community service organizations now not subject to income tax under the provisions of Section 501(c)(3) of the Internal Revenue Code of 1954, as amended. Current and accumulated income of "Private Foundations" is ultimately distributed to tax-exempt organizations most of which are exempt under Section 501(c)(3) of the Internal Revenue Code of 1954, as amended (hereinafter referred to as Code).

In its own case the Wilmington Medical Center is dependent heavily on contributions from "Private Foundations." For example, in the seven years ending with 1968, hospitals comprising part of the Wilmington Medical Center conducted two major building fund campaigns. One of these resulted in receipt of approximately 6.6 million

dollars, 26 percent of which ($1,700,000) came from Private Foundations located in the Wilmington metropolitan area. In the second campaign, 3.25 million dollars was received, 16 percent of which ($508,000) came from Private Foundations located in the Wilmington metropolitan area.

In addition to soliciting for capital funds, the Wilmington Medical Center conducts annual fund-raising campaigns to provide continuing support to the operations of the Center. In the past few years, the annual fund-raising has raised approximately $1,350,000.00, 40 percent, or $540,000, of which has been donated by Private Foundations. As can be seen from Exhibit "A", projecting an operating deficit of 3.5 million dollars before application of approximately the 1.7 million dollars of endowment income for fiscal year 1970, the Wilmington Medical Center must, in the future, rely heavily upon donations from all sources to continue to provide for present operating needs.

Thus, Wilmington Medical Center's concern with the proposed tax on Private Foundation's investment income is obvious. If an income tax of 7 1/2 percent is levied on the income of Private Foundations, it is equivalent to levying a tax of 7 1/2 percent on the donations of Private Foundations to the Wilmington Medical Center. Frankly, in a period of time of rising operating and building costs, eleemosynary institutions, such as Wilmington Medical Center, cannot afford any reduction in sources of funds. In this regard, it should be noted that operating costs at Wilmington Medical Center have risen approximately 10 percent per year for the past three years (typical of similar hospitals throughout the country). Also, it should be noted that hospital construction costs are presently rising at the rate of 1 percent per month.

The significant support provided by Private Foundations is not a situation unique to the Wilmington Medical Center. Personnel at the Center polled all the hospitals in the State of Delaware, as well as hospitals in Pennsylvania and Maryland adjacent to the Wilmington Medical Center service area. These hospitals echoed our experience with respect to raising funds and the support received from Private Foundations in their campaigns.

The response of these hospitals was as follows (all of which were approximations):

(1) Chester County Hospital, West Chester, Pennsylvania - This hospital reported that it had had two building fund drives. One in 1960 dealing with a building, the cost of which was $400,000. Private Foundations contributed 90 percent of the cost or $360,000. The second building fund drive was in 1965 to support a building program costing $1,200,000. Private Foundations contributed $471,000, or 39 percent of the cost.

(2) Milford Memorial Hospital, M lford, Delaware - This hospital reported that it is presently undertaking a building program of 3.5 million dollars. At the time of the report, the only contributions which had been received were $275,000 from two Private [illegible]dations. We understand that 1.7 million dollars will be borrowed, $500,000 will be raised from a community fund-raising campaign and the balance hopefully financed

from an accumulation of operating income derived by including prospective funding in patients' charges.

(3) Kent General Hospital, Dover, Delaware -
This hospital reported total contributions of 1.1 million dollars in connection with its building program of which $211,000, or 19 percent was received from Private Foundations.

(4) Nanticoke Memorial Hospital, Seaford, Delaware -
This hospital reported total contributions from 1965 through 1969 of $482,000, all of which came from Private Foundations.

(5) Kent and Queen Anne Hospital, Chestertown, Maryland -
This hospital reported a building program of 1.4 million dollars, $900,000 of which was contributed, including $100,000 from one Private Foundation.

(6) Beebe Hospital, Lewes, Delaware -
This hospital reported two foundation grants of $55,000 toward the total cost of $1,474,000. Hill-Burton funds were secured in the amount of $425,000. An additional $500,000 was borrowed with the balance coming from contributions.

In addition to providing current direct financial support to eleemosynary institutions, such as the Wilmington Medical Center, Private Foundations perform an additional task which under the laws of the State of Delaware, such institutions cannot perform for themselves. Delaware laws do not grant such institutions the right of eminent domain to acquire land for either current or anticipated future needs.

Fortunately, the Wilmington Medical Center recently received from a local Private Foundation approximately 200 acres of land to use for building expansion necessary to keep the Center's facilities current with the growing population. The land was purchased with great foresight at an earlier date by the Foundation and held for the purpose of donating it to an eleemosynary institution as the need arose. An additional 390 acres adjacent to the tract is still held by the Foundation in reserve for use by other eleemosynary and public institutions as the community needs develop for further expansion of such organizations. In effect, the acres still held by the Private Foundation are a land bank for community purposes. By its action, this Foundation performed a unique and important contribution in a small territory such as Delaware. In our State which is growing rapidly open land in the metropolitan areas is becoming non-existent.

It should be pointed out that up to the present, taxes in the State of Delaware and its political subdivisions have not been inordinately

heavy. In a large part this is owing to the existence of local Private Foundations and generous individuals. The proposal to tax investment income of Private Foundations will reduce their ability to continue to support community programs (such as hospital services) in the amounts they had in the past. It is folly to reduce these sources of funds at a time when rising costs and increased indigent patient loads necessitate our turning to governmental sources for additional funds for both operational expenses and capital outlays.

III. OPPOSITION TO SECTION 101(b) OF H.R. 13270 TAXES ON FAILURE TO DISTRIBUTE INCOME.

Any provision which may tend to discourage contributions to eleemosynary institutions, such as the Wilmington Medical Center, should not be given favorable consideration by the Senate Finance Committee. The provision dealing with taxes on failure to distribute Private Foundation income falls in this category.

This provision requires the annual payout of all the net income of a Private Foundation but not less than 5 percent of its investment assets.

While this provision permits accumulation for specific projects with prior approval by the Internal Revenue Service, it appears to leave Private Foundations at the mercy of a subjective determination by an Internal Revenue Agent rather than with individuals responsible for and

knowledgable of the intents and purposes for which the foundation was created.

Further, as can be seen from the illustrations already given in II above, at least in Delaware, Private Foundations acquiring acreage as a land bank has proven extremely beneficial to the entire community. To discourage such functions by either forcing untimely distributions or taxing retention of property does nothing more than force eleemosynary institutions, such as the Wilmington Medical Center, to look to the Federal and State governments to provide the resources formerly provided by the Private Foundation sector.

IV. OPPOSITION TO SECTIONS 201(a) AND 201(c) OF H.R. 13270 TREATMENT OF CHARITABLE CONTRIBUTIONS OF APPRECIATED PROPERTY.

Consistent with the position taken by the Wilmington Medical Center in opposition of legislation discouraging charitable contributions as set forth in II and III above, the Wilmington Medical Center opposes Section 201(a) of H.R. 13270 to the extent that it does not permit deduction of contributions of appreciated property up to the increased limitation of 50 percent of adjusted gross income. If the intent of the provision is to increase the incentive to make charitable contributions, the nature of the asset to be given to charity should not inhibit the donors' incentive to give to charity. In our experience, a

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large percentage of the contributions received by the Center have been in kind rather than in cash.

The provision of Section 201 (c) of the Bill dealing with the donor of certain types of appreciated property to Private Foundations tends to do nothing more than inhibit charitable contributions and thus, reduce the source of funds for such eleemosynary institutions as the Wilmington Medical Center.

V. OPPOSITION TO OTHER SECTIONS OF H.R. 13270 AFFECTING CHARITABLE CONTRIBUTIONS.

For the reasons stated heretofore, Wilmington Medical Center also wishes to go on record opposing those other provisions of H.R. 13270 which would inhibit rather than encourage charitable contributions. The provisions to which reference is made are:

(1) Section 201(a) - Disallowance of charitable deduction for gift of use of property.

(2) Section 201(f) - Elimination of the set aside deduction presently allowed estates and trusts.

(3) Section 201(g) - Repeal of the two-year charitable trust rule.

(4) Sections 201(e), (f), (h) and (i) - Requiring that charitable remainder trusts be either an annuity trust or a unitrust.

(5) Sections 201(a) and (h) - Requiring that charitable income trusts provide an annuity to charity or a fixed percentage of annual fair market value and requiring that the grantor is taxable on the income unless all the interests in the trust are given to charity.

(6) Sections 301 and 302 to the extent that such sections have the effect of reducing the benefit received by a donor from a charitable contribution of appreciated property and require the donor to allocate a portion of the charitable contribution deduction to non-taxable income thus reducing the amount of the deduction.

VI. CONCLUSION

In a period of time when operating and construction costs of eleemosynary institutions are escalating at a rapid pace, Federal and State governments should adopt legislation which encourages rather than discourages charitable contributions to such institutions. Otherwise governmental bodies will need to provide the services themselves. We believe that this would be at a cost much greater than the revenue dollars lost by granting incentives to give to charity.

ndowment turns into deficit

Charity-care cost drains Medical Center

Charity care will bring an operating loss of more than $2.25 million to the Wilmington Medical Center for the fiscal year that will end Tuesday.

Dr. John A. Perkins, president, told the center's executive committee yesterday that the loss lends new urgency to the suggestion made by Ralph K. Gottshall, board chairman, that the center re-examine its policy of providing free care.

THE direct result of the loss, Perkins said, is that the center is confronted with a deficit of $500,000 after endowment income of $1.7 million has been applied to reduce the loss.

"Our operating deficit is solely due to the fact that we are being asked to provide upwards of $3 million a year in free care to persons who cannot afford to pay for themselves," Perkins said.

Projections indicate that next year the operating deficit will be $3.5 million on a conservative estimate. Gottshall projected a figure $200,000 less than the $2.25 million total in a report to the center's trustees a week ago. He spoke before a final accounting had been made for the month of August; August showed a sharp rise in the operating deficit.

"It is not right that charity costs should more than eat up the Wilmington Medical Center's endowment income," Perkins said. "In most other respects, the government, federal state or local, pays basic welfare costs. Private charity became a supplemental source of welfare support as long ago as the mid-30s. Yet nonprofit hospitals are asked to continue this ever heavier burden that has exceeded the ability of private resources to shoulder.

"THE medical center's modest endowment income is badly needed for other purposes. As long as it must be diverted to cover the cost of nonpaying patients, the medical center will be unable to make all the advances in general patient care, education and research, and the renovation of existing structures and the building of new ones that are necessary to achieve the stated purposes of merger set forth in 1965."

At this point Perkins told the executive committee of the urgency given Gottshall's suggestion, made to the trustees a week ago. At that time Gottshall said:

"New Castle County has withdrawn its limited support to the charity programs of hospitals and the state has undertaken to assume the county's obligation to the extent of $510,000 per year. The fact that the money comes from a different source does not affect the fact of this inadequacy of income in relation to the problem as it exists in the medical center....

"THE question has to be raised as to what other steps might be taken if state, county and city support in realistic amounts is not forthcoming.

"As matters stand, to a considerable extent, some of this problem of financing charity and education is passed on to the paying patient, but 65 per cent of our patients are covered by third-party contract agreements which limit or prohibit allocating to them the full amount of these charity costs.

"I am sure that none of us agrees with the concept that the paying patient should carry the community burden of the indigent patient, which in a sense is a form of hidden taxation, but the money must come from somewhere. . . How we resolve this problem will be a large measure affecting the role of the medical center and the program it has tentatively outlined for itself."

EXHIBIT A

PART B—ADDITIONAL STATEMENTS

STATEMENT OF SENATOR PAUL FANNIN

Mr. Chairman, I would like to point out at this time my special interest in this amendment (NO. 144) with respect to the disabled. For almost 30 years, legislation for this purpose has been introduced in Congress. The Senate indicated its support in 1964 when it adopted an amendment for this purpose to the general tax revision law. Unfortunately, it was struck from the bill during the conference.

At present, a tax exemption is recognized for the blind, and rightly so. However, there are other disabilities, such as paraplegia, quadraplegia, multiple amputations and so forth, for which recognition is not given. Existing law, therefore, in discriminatory fashion, makes it exceedingly difficult, if not impossible, for the disabled and the handicapped to be gainfully employed by depriving them through the tax laws of that margin of income that means the difference between welfare or pension and economic independence.

The private insurance industry paid out a total of $5,029,449,000 for income losses to the disabled in calendar year 1967. The Social Security Administration paid $2,294,256,000 for calendar year 1968 to disabled individuals and their dependents. The Federal government pays approximately $15,000 per year to maintain one veteran in a veteran's domiciliary. Social Security pays in the neighborhood of $40,000 during the lifetime of one disabled individual.

The figure I have seen as to total loss of revenue to the Treasury which would result from the enactment of this amendment is

$40 million per year. Even this figure is misleading on its face because it does not take into consideration the taxes which would be paid into the Treasury by those disabled who would be joining the work force. It seems obvious to me that we are pursuing a false economy by denying these individuals a deduction for transportation expenses and an exemption to provide their own aid and attendance.

The Social Security Administration has a Trust Fund set aside for the rehabilitation of disabled individuals and is willing to spend as high as $10,000 if necessary to rehabilitate <u>one</u> of these people if that person can be removed from its rolls. A recent study made by the Center for Transportation Studies, Rutgers University, revealed that of those included in the sampling, ". . .merely 53% of those who had received costly rehabilitation and placement services during the preceding two years were still employed." The study indicates that immobility or the inability to use public transportation facilities counted as a prime factor in the unemployment rate of those receiving the complete rehabilitation process. Thus, because of our discriminatory tax laws, we are throwing considerable tax money down the drain. More tragically, human dignity and endeavor are being washed away with it.

I am sure the testimony today will delineate the problems and specifics involved here. I would like to make one other observation. When an individual goes to work, his physical condition does not change. His source of income <u>does</u> change, however, and it is obvious that his motivation is severely affected if his net income is <u>less</u> while

working than it was while drawing a pension. If after a long trial of work he can see no reward, it is only reasonable to expect him not to work. This cannot be the result intended by Congress or the Executive and I would hope this situation will be remedied through the enactment of this proposal.

SECTION ON TAXATION

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October 1, 1969

Committee on Finance
Senate of the United States
Washington, D. C.

Re: <u>H.R. 13270</u>

Gentlemen:

Set forth in this letter and the accompanying attachments are the comments of the Section on Taxation of the Philadelphia Bar Association in its study of H.R. 13270, referred to as the Tax Reform Bill of 1969.

The study made by the Section on Taxation was not concerned with the broad social, economic and political considerations related to the proposed legislation. Rather, the study was undertaken to determine whether the provisions of the Bill raise questions or present problems of inconsistency, omissions, or unintended benefits or hardships.

The comments submitted herewith have been approved by the membership of the Section on Taxation, involving approximately 150 practicing lawyers specializing in the field of taxation. Contained in this letter are comments on three subjects of broad scope raised by the proposed legislation, namely questions of retroactivity, effective dates and special purpose legislation. In the attachments accompanying this letter are comments of a technical nature with regard to specific provisions in the Bill identified at a later point in this letter.

(a) <u>Retroactivity</u>. Several of the provisions in the Bill alter considerably the taxation of investments which were committed prior to the effective date of the proposed legislation. Perhaps the outstanding example of such investments is the purchase of state and local bonds which at the time were free of Federal income taxation. Section 301 (a) of the Bill, if applicable, would tax such

interest notwithstanding that the indebtedness in question was acquired by the taxpayer prior to enactment and even prior to any serious proposal being offered to tax such securities. While the proposed change in law would be applicable to years beginning after December 31, 1969, the legislation is retroactive in the sense that it applies so as to materially and adversely affect an investment made prior to the effective date.

Other types of transactions affected in the same manner are the equipment and real estate ownership and leasing ventures undertaken at a time when obtaining accelerated depreciation and interest deductions in the full amount available under the law were material inducements in making the investment. Our review has disclosed that economically sound ventures previously entered would be converted into a net economic loss by reason of the denial of deductions for interest and accelerated depreciation by the operation of Section 302 of the Bill (the allocation of expense proposal), and to some extent Sections 221 (the limitation of interest deduction proposal) and 301 (the limitation on tax preference proposal). Subjecting accelerated depreciation on real estate assets previously acquired to full recapture in the event of sale (Section 521(b) of the Bill) would also substantially change the economic feasibility of many existing real estate transactions.

In the case of all such rental transactions, the tax law made it feasible for lessors to enter into low rental deals with lessees who, by paying less rent, thereby generated more income subject to tax or, in the case of Government lessees (such as in the case of the Post Office leasing program), provided the Government with a bargain rental that was possible only because of the tax saving by reason of deducting all of the interest and accelerated depreciation related to the transaction, as well as being able to realize a capital gain on the later disposition.

With respect to all of the foregoing, the proposed changes in the tax law referred to will create an unreasonable hardship. Fundamental fairness should require that, as in the case of the repeal of the investment credit (as well as its suspension in 1966), the new rules should be applicable only with respect to transactions entered after the effective date and should exempt transactions entered prior to that time. No matter how clear the case for repeal or change in the law is, a taxpayer would be treated unduly harshly by a change in the rules after he had made economic commitments in good-faith reliance on existing law.

In Section 521 of the Bill, changes are made in the rules relating to the depreciation of real estate, but those rules are not made applicable with respect to transactions which were undertaken or committed prior to the date specified in the Bill. No satisfactory reason appears for failing to except from the operation of the following provisions of the Bill transactions consummated or property acquired, constructed, reconstructed, or erected pursuant to a binding contract entered into before a specified effective date:

(i) Limitation on deduction of interest--Section 221 of the Bill.

(ii) Limitation on tax preferences, particularly with reference to tax-exempt municipal bonds and accelerated depreciation of assets previously acquired--Section 301 of the Bill.

(iii) Allocation of deductions, particularly with reference to accelerated depreciation of assets previously acquired (as an item of preference) and interest incurred with regard to the purchase of assets previously acquired (as an allocable expense)--Section 302 of the Bill.

(iv) Accumulation trusts, relating to the taxation of prior accumulations in the case of existing trusts that would otherwise not have accumulation distributions subject to tax--Section 341 of the Bill.

(v) Real estate depreciation recapture, with respect to accelerated depreciation of assets previously acquired--Section 521 of the Bill.

The policy decision to put an end to tax shelter devices is not challenged; that is a question as to which reasonable minds may differ. However the basic inequity in altering the tax treatment of transactions entered at a time when the tax law clearly provided an incentive to make such an economic commitment is indisputable, particularly when persons entering into such transactions had every reason to make the good-faith assumption that the tax laws would not be changed in a manner which would substantially prejudice their position. The proposed changes in the law will not simply result in a greater tax being paid; in many instances

the proposed changes will result in the investor incurring more tax than economic benefit by reason of his having made the investment. Such a set of rules should not be applied to a transaction undertaken prior to the change in the law.

(b) Effective Dates. The Bill contains a variety of effective dates, many of which predate enactment and, indeed, predate the actual submission of the Bill. In most of such instances, the proposed effective date coincides with the day when a Treasury Department official or a member of Congress proposed a change in the law. While many such pronouncements were widely publicized, certainly most of the general public and a substantial number of tax practitioners were not immediately informed regarding the possibility of a change in the law. Moreover, until a Bill is submitted the scope of the proposed change is unclear.

In many instances the proposed changes with respect to which early effective dates are in the Bill are not of the sort which should require the change to be made as of the date the proposal was first mentioned prominently. For example, a change in the installment sales rules has a proposed effective date of May 27, 1969, notwithstanding that the revenue effect of a later date would be inconsequential as a matter of national significance. To the uninformed parties who did not tailor their transactions to the revised rules, the tax hardship could be serious. To permit installment sales, for example, or for any of the more truly "loophole plugging" provisions to become effective at or after enactment will certainly not upset any established rule of propriety.

Holding to an effective date of April 18, 1969 with regard to the repeal of the investment tax credit is understandable; insisting upon an effective date prior to enactment with regard to the installment sale provision, the repeal of the alternative capital gain tax, the change in the treatment of long-term capital losses, the elimination of accelerated depreciation in the case of the acquisition of used real estate, and many other such retroactive dates serve only to create administrative problems and hardships in the case of those taxpayers who are less likely to have a continued relationship with a tax advisor, and is inconsistent with basic principles of fairness.

It is suggested that, except with regard to the repeal of the investment tax credit, the effective dates should not precede the date of enactment and in many instances should conform to more easily identifiable points in time such as the end of the calendar year.

(c) Special Legislation. The Internal Revenue Code has been criticized for the special legislative enactments forming part of it which have nothing whatever to do with a broad-based and generally applicable set of principles dealing with the taxation of the nation's income and the distribution of its burdens. Special provisions applying broadly to farmers, small business, natural resources, financial institutions and the like are justifiable because distinctions are often appropriate to be made as a matter of national tax policy. However, the narrow attempt to make certain so-called conglomerate acquisitions less attractive, though possibly justifiable as an anti-trust measure, has no relevance as a matter of national tax policy, either from the standpoint of raising revenue or distributing its burdens.

Specifically, Section 411 of the Bill erects a set of artificially contrived rules that cannot be justified except on the basis of concluding that a line would have to be drawn somewhere. To include within the framework of a presumably broad-based taxing act a limited scope provision such as Section 411, which might not catch the "worst offenders" and has a relatively negligible revenue estimate, is not justifiable. Section 411 fails in regard to the questions of consistency, and beyond that it is not practicable to assess the potential unintended benefits or hardships that may be realized by reason of the involved standards set forth.

Attached to this letter, but an integral part hereof, are comments with regard to specific provisions contained in the Bill. The comments with respect to each of the following sections of the Bill are contained in attachments lettered as indicated below:

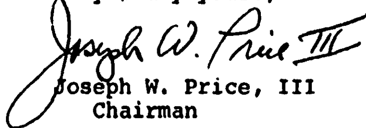
Section 101	"A"
Sections 211-13	"B"
Section 221	"C"
Sections 301-2	"D"

Section 331	"E"
Sections 341-42	"F"
Sections 411-14	"G"
Section 421	"H"
Sections 431-32, 452	"I"
Section 461	"J"
Sections 511, 515	"K"
Section 521	"L"
Section 541	"M"
Sections 601-2	"N"
Section 703	"O"

The comments contained in this letter and the accompanying attachments arose out of the study undertaken by members of the Section on Taxation solely for the purpose of providing the Senate Finance Committee with the benefit of the technical knowledge and experience of the tax bar of Philadelphia. Although a variety of viewpoints with regard to the wisdom of the proposed changes has been expressed by the members of the Section, no attempt was made to evaluate the Bill in terms of its political, social or economic aspects. The indulgence of your Committee and staff in reviewing the comments would be greatly appreciated.

We hope that these comments will be of benefit to the Committee, and if further elaboration is considered desirable, please do not hesitate to call upon the Section.

Very truly yours,



Joseph W. Price, III
Chairman

Attachments

COMMENTS RELATING TO
SECTION 101 OF H.R. 13270

(a) Section 4943 - Uncertainty in voting percentage test.

The permitted holdings by a private foundation in a business corporation is limited to "20 per cent of the voting stock." How is that percentage to be determined? Are options to purchase shares, conversion privileges into or out of voting shares, and similar share potentials to be considered?

We would favor considering maximum option exercises in determining outstanding shares, but in any event we suggest that some clear-cut rule be adopted.

(b) Section 4943 - Disposal of excess holdings.

The provisions of Section 4943 appear to infer that a foundation must dispose of shares to reduce its holdings to the required maximum percentage of voting stock. Why is the foundation required to "dispose" of shares to reduce its holdings, when its holdings can be reduced in other ways? For example, can the issuance of additional shares or reduction in proportionate voting by the foundation's shares satisfy the reduction requirement? If such methods of reduction are considered permissable, the Bill or committee report should so state; if such methods of reduction are not considered permissable, that intention should also be clarified and hopefully reconsidered.

(c) Section 2055(e) - Estate tax deduction.

The blanket denial of deduction for certain charitable bequests does not take into consideration the existence of irrevocable trusts providing gifts to charity, where the corpus will be included in the decedent's gross estate because of retained interests, etc., but no deduction is allowed under the Bill. Similarly, existing wills of decedents who will die shortly after enactment may provide for a pour-over to an existing trust that provides for a charitable gift that will not be deductible.

In each of the foregoing cases the parties may be powerless--either legally or practically--to change

"A"

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the terms of the trust. Some relief should be afforded by exempting trusts which cannot legally be altered and by providing a one-year transition period to get wills straightened out.

(d) Section 642(c) - Amounts Set Aside for Charity.

The Bill proposes to repeal the deduction for amounts set aside by an estate to make gifts to charity. Since typically estates make no distributions during administration, estates should be permitted to deduct such accumulations since otherwise all income during probate would be subject to tax.

Where a trust provides for income payments to an individual for life with the remainder going to charity, capital gains allocable to corpus (and hence not includible in distributable net income) would be subject to tax.

The deduction now permitted by Section 642(c) should be continued for amounts not includible in distributable net income.

(e) Section 509(a)(3) - Definition of a Private Foundation.

The Bill excludes from the definition of a private foundation organizations which are organized and operated exclusively for the benefit of a so-called 30 per cent charity under existing law, provided that the organization is "operated, supervised or controlled by" a so-called 30 per cent organization and it is not controlled by a disqualified person. The terms "operated, supervised or controlled" are not defined in the Bill and the Committee Report does not clarify the intended use of the terms except to refer to certain examples of organizations expected to qualify.

Because the functioning of the organization is stated in the disjunctive, each of the words "operated, supervised or controlled" requires a definition, or as a minimum the functions of the private foundation which are to be subject to supervision or control should be set forth. In view of the fact that the major thrust of the changes in regard to private foundations has to do with insuring the proper use of funds and the channeling of such funds to appropriate organizations, it is suggested that the definition be addressed to those objectives.

Accordingly, in view of the fact that subsection 509 (a)(3)(A) requires the organization to benefit a public charity, it would seem that the "control" test should be met if the public charitable organization has responsibility for control and investment of funds, notwithstanding that the designation of the specific charitable beneficiary would be determined by a person other than an organization described in subparagraphs (1) or (2) of Section 509(a). This is certainly the case when all of the income of the foundation is to be disbursed for charitable purposes annually and the period of time during which principal may be retained by the foundation is limited by an ascertainable standard.

It is recommended that subsection (c) be added to Section 509, to read as follows:

> "(c) RULE FOR APPLYING PARAGRAPH (a)(3)(B). - In applying subparagraph (B) of paragraph (a) (3), an organization is operated, supervised, or controlled by an organization described in paragraph (1) or (2) if the following conditions are met:
>
> > "(1) all of the income of the organization is required to be distributed annually; and
> >
> > "(2) the assets are held, and the investment and disbursement thereof are supervised, by one or more organizations described in subparagraph (1) or (2) of paragraph (a)."

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COMMENTS RELATING TO
SECTIONS 211, 212 and 213 OF H.R. 13270

(a) Section 1251(d) - Application to Subchapter S Corporations.

In the case of a partnership, proposed Section 1251(d)(5) provides that each partner is to take into account separately his distributive share of items of the partnership which are relevant under this section. Why is there no similar provision made for Subchapter S corporations?

A new subparagraph should be added to Section 1251(d) to provide that, in the case of a Subchapter S corporation, each shareholder's share of items which are relevant to the application of Section 1251 should be taken into account separately by him, and then the limitations of Section 1251(b)(2) should be applied at the individual level.

(b) Section 1251(b)(3) - Carry Back of Farm Net Losses.

Where a taxpayer has an income from farming operations for one or more years and then has a farm net loss within the meaning of proposed Section 1251 (e)(2), the Bill would apparently require the addition of the farm net loss to the excess deductions account if the net loss was either offset against non-farm income for the same year, or if the loss was carried back and offset against income from farming operations during the three preceding years.

This causes an unintended hardship, for example, in the case where a taxpayer realizes farm net income during the first year to which proposed Section 1251 applies, and in the second year realizes a farm net loss which offsets non-farm income for that year. That taxpayer will be required to add the farm net loss to his excess deductions account, without any reduction in that account for the farm net income realized in the previous year. However, if, for instance, a farm net loss was incurred in the first year to which

"B"

proposed Section 1251 would apply, and then the taxpayer had offsetting farm net income in the following years, the excess deductions account would be eliminated. Obviously, the result should not depend on the sequence of the loss and profit years.

We would suggest that the following new subparagraph (C) be added at the end of proposed Section 1251(b)(3) (after deleting the word "and" at the end of subparagraph (A) and inserting it at the end of (B)):

> "(3)...there shall be subtracted from the account -
>
> * * * *
>
> (C) an amount equal to the farm net income for any year to which a farm net loss could have been carried back under Section 172 (relating to the net operating loss deduction)."

(c) Sections 1251(b)(5)(A) and 1251(d) - Transfers to Controlled Corporations.

Taking into account the effect of proposed Sections 1251(b)(5)(A) and 1251(d), there is a seemingly unfair result to an individual who transfers his farming business to a controlled corporation.

Although proposed Section 1251(b)(5)(A) does not provide for the transfer of the excess deductions account to a corporation in a Section 351 transaction, proposed Section 1251(d)(3)does provide that there will be no gain recognized, generally speaking, on the disposition of "farm recapture property" in a Section 351 transaction. Rather, proposed Section 1251(d)(6) seeks to tax the gain following a Section 351 transaction by treating a proportionate amount of the stock received in a Section 351 transaction as "farm recapture property".

The inference from these provisions seems to be that if an individual transfers his farming business to a

controlled corporation under Section 351, he himself would retain the excess deductions account, and his corporation would create one only if it subsequently experiences farm net losses. We believe that it would be more equitable to provide for a transfer of the excess deductions account to the corporation, so that subsequent farm net income from the transferred business could be used to reduce or eliminate the excess deductions account. This particularly should be so where the proprietor of the farm business is the controlling shareholder of the transferee corporation (i.e., in situations where there are no other transferors who join in the plan of reorganization). To accomplish this result, we suggest that the references, in proposed Section 1251(b)(5)(A), to Sections 371(a), 374(a) and 381 be deleted and that proposed Section 1251(d)(6) be deleted in its entirety.

(d) Section 1251(d)(5)(B) - Gain on Transfers to Partnerships.

Although Sections 1245 and 1250 of the present law (on depreciation recapture) provide that no gain is to be recognized under those sections to a contributing partner if Section 721 applies, proposed Section 1251(d)(5)(B) inconsistently, and we believe inequitably, requires the recognition of ordinary income to a partner under Section 1251 upon his contribution of farm recapture property to a partnership, so long as the other partners contribute no farm recapture property or contribute farm recapture property having a lesser value. Under proposed Section 1251(d)(5)(B), it will only be the well advised taxpayer that will be able to avoid recognition of gain on the contribution by including in his partnership agreement a provision allocating to the contributing partner all gain upon the disposition of farm recapture property contributed by him.

As we previously suggested in the case of the transfer of farm recapture property to a controlled corporation, we, here, also suggest that no gain be recognized on the transfer of farm recapture property to a partnership, but rather that proposed Section 1251(b)(5)(A) be amended to provide for the carry over of the excess deductions account to the partnership. Proposed Section 1251(d)(5)(B) would be amended accordingly, and would also add that any gain in the

subsequent disposition of the farm recapture property could, if so provided in the partnership agreement, be allocated exclusively to the contributing partner. This suggestion would allow any excess deductions account inherited from the contributing partner to be eliminated by subsequent farm net income. This result, we believe, is more equitable than requiring a partner to recognize gain, even though subsequent farm net income is sufficient to eliminate the excess deductions account of the partnership or of the contributing partner.

(e) Section 1251(e)(2),(3) - Application of Net Operating Loss Deduction to Definition of Farm Net Income and Farm Net Loss.

The definition of farm net income in the Bill is simply the excess of the gross income derived from the trade or business of farming over the deductions allowed or allowable by Chapter 1 which are connected with that business. Literally, a net operating loss deduction arising from a carry back or carry over of a net loss from a subsequent or preceding year, would be a deduction allowed by Chapter 1 and would reduce farm net income for the current year.

This result is presumably unintended since the loss itself in the year of origin would result in an addition to the excess deductions account. We recommend that proposed Section 1251(e)(2)(A) be amended to exclude deductions in Chapter 1 allowable under Section 172 (net operating loss deduction).

(f) Section 1251(e)(4) - General Definition of Farming.

We believe that a general definition of "farming", now absent from the Bill itself and from the House Ways and Means Committee report, is appropriate. Although such a definition is not necessary in the Bill itself, we suggest that the definition presently contained in Sections 1.61-4 (d) and 1.174-3 of the Regulations be incorporated at the appropriate place in the report of the Senate Finance Committee.

B-4

(g) Section 1251 - Effective Dates.

We suggest that the effective date provisions of the Bill be clarified in the Senate Finance Committee's general and technical explanations to indicate that:

1. Deductions allowable with respect to farm land under existing Sections 175 and 182 for taxable years beginning before December 31, 1969 do not have to be taken into account for purposes of proposed Section 1251(e)(3).

2. If our proposal is adopted to change proposed Section 1251(b)(3) to allow farm income for a preceding year to be taken into account in reducing an excess deductions account, then only farm net income for years beginning after December 31, 1969 should be taken into account.

(h) Section 1231(b)(3) - Clarification of Definition of Livestock.

Proposed Section 1231(b)(3) refers to "livestock" held "at least 365 days after such animal normally would have first been used" for draft, breeding, sporting, or dairy purposes. We believe that there must be some clarification regarding the precise date that the holding period begins.

We suggest that the Senate Finance Committee's report provide that the Regulations will incorporate certain presumptions as to the time or age at which animals of various breeds will normally be considered to be usable for draft, breeding, sporting or dairy purposes.

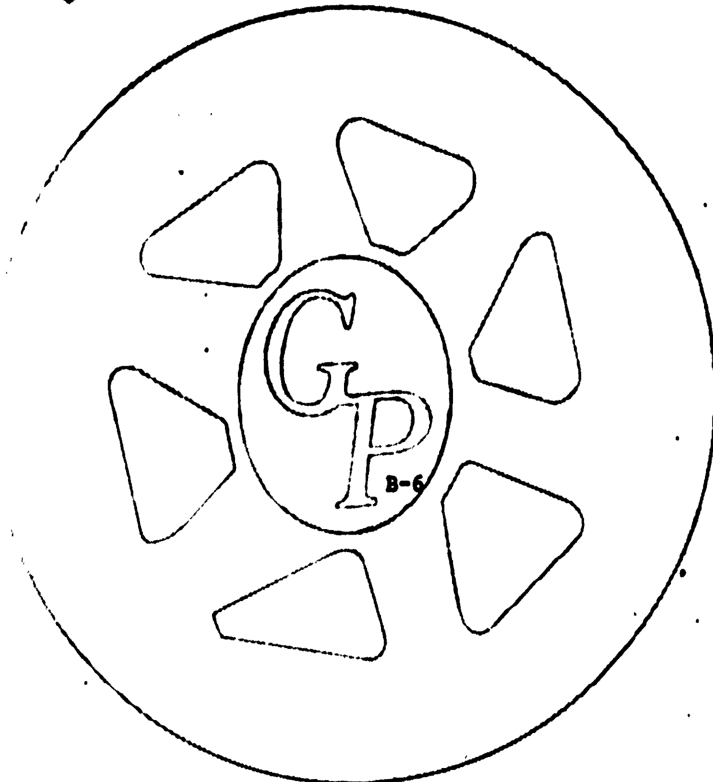
(i) Section 270 - Use of the Term "Activity".

Proposed Section 270 discards the phrase "a trade or business" in present Section 270 in favor of the term "activity". We do not understand why this change was made, unless the term "activity" is intended to cover activities described in existing Section 212.

We believe also that the use of the term, "activity", coupled with the elimination of the exception in present Section 270 for "specially treated deductions", creates additional confusion. The proposed amendment to Section 270 is so broadly worded that the Service could contend that the deduction of items such as interest and taxes, if attributable to a business or other activity which the Service thought was not carried on with an expectation of making a profit, could be disallowed even though they are expressly deductible under Code sections other than 162 and 212.

We suggest that the word "activity" be deleted throughout the new Section 270 and that the phrase "trade or business or an activity described in Section 212" be reinserted. We also recommend that the following new subsection be added to Section 270:

> "(c) LIMITATION. - Nothing in this section would prevent the deduction of any item which is otherwise deductible under the provisions of this Chapter whether or not it is connected with the carrying on of a trade or business or with an activity described in Section 212."



COMMENTS RELATING TO
SECTION 221 OF H. R. 13270

(a) Section 163(d)(4)(A) - Limitation on Partnerships.

Since the provisions of proposed Section 163 (d)(4)(A) are to apply at the partnership level, the result that will follow with regard to certain partnerships is that where the partnership suffers a loss, interest expenses will be deductible only to the extent of $25,000 and that amount will have to be allocated among all the partners even though there may be a substantial number of them. Thus, the partners would not be able to deduct their proportionate share of the interest expense even though they had other net investment income or long-term capital gains.

Especially in view of the fact that an individual's proportionate share of a partnership loss would reduce other investment income, this result appears unduly harsh, and we recommend that proposed Section 163(d)(4)(A) be deleted.

(b) Section 163(d)(1) & (2) - Order of Applying Carry Forwards of Disallowed Investment Interest.

Both proposed Sections 163(d)(1) and (2), and the proposed amendment of Section 1202 cannot be properly applied unless there is clarification whether investment interest is allowed first in the amount of $25,000, then in the amount of the net investment income, and lastly, in the amount of net long-term gain, or in some other manner.

We recommend that the Bill specify the order of allowance of investment interest, and specifically substitute the following language for so much of Section 163(d)(1) as preceeds subparagraph (a):

"(1) IN GENERAL - In the case of a taxpayer other than a corporation (except an electing small business corporation as defined in Section 1371(b)), the amount of interest allowable as a deduction shall be limited to the sum of the following amounts and shall be allowed in the following order-..."

"C"

(c) Section 163(d)(3)(A) - Uncertainty in Definition of Investment Income.

No provision is made in the Bill's definition of investment income for the inclusion of recapture income with respect to property such as rental property or a franchise which may give rise to investment income. But for Sections 1245, 1250 or proposed Section 1252 these amounts would be capital gains and presumably the type of income which it was intended could be offset by investment interest. We recommend that the Bill be amended to so provide.

Proposed Section 163(d)(3)(A) does not make it clear whether tax exempt interest qualifies as "interest" and, therefore, investment income. If it does not, then it is not clear whether that portion of tax exempt interest required to be taxed by Bill Section 301 relating to limit on tax preferences would qualify as investment income. The Bill should be amended to specifically provide that all includible income from interest is included in investment income.

The Bill includes in investment income net short-term capital gains only if they are derived from the disposition of property held for investment, while, no such limitation is placed on income from interest, dividends, etc. Furthermore, the question of whether investment is to be distinguished from "speculation" arises. We recommend that the Bill be amended so that the only limitation on investment income is to income not derived from a trade or business, and this limitation should apply equally to all items.

An amended Section 163(d)(3)(A) should be rewritten, as follows, to effect the three recommendations made above:

> "(A) INVESTMENT INCOME - The term 'investment income' means the gross amount of includible income from interest, dividends, rents and royalties, recapture income described in Sections 1245, 1250, 1251 and 1252, and net short-term capital gains derived from the disposition of property but only to the extent that such gross income or such gains are not derived from the conduct of a trade or business."

(d) Section 163(d)(3)(B) - Reduction of Investment Income by Nondeductible Expenses.

Investment expenses are defined in the Bill as all deductions allowable under Section 164(a)(1) or (2), 166, 167, 171, 212 or 611 directly connected with the production of investment income. However, the Bill fails to take into account those expenses which, pursuant to Section 302 of the Bill relating to the allocation of deductions, are not deductible. It is not presently clear whether or why investment income should be reduced by such expenses.

We recommend a revision of Section 163(d)(3)(B) to make it clear that otherwise deductible items, which are disallowed under proposed Section 277 are not included in investment expenses.

(e) Section 163(d)(3)(D) - Uncertainty in Definition of Investment Interest.

The definition of investment interest fails to advise the taxpayer how substantial the motive to "purchase or carry property held for investment" must be. Must the indebtedness be incurred solely to purchase investment property, or need the desire to purchase investment property be only one of a number of motives. We recommend that there be a requirement that the motive to carry property held for investment be the primary motive for incurring the debt.

The provision should also be clarified to recognize the possibility that all "investment income" need not always arise from "investment" property; it may also arise from property held for the production of long-term capital gains.

COMMENTS RELATING TO
SECTIONS 301 AND 302 OF H.R. 13270

(a) Section 277 - Need for Basis Adjustment.

While proposed Section 218(c) provides that disallowed tax preferences attributable to Section 1250 property and to certain farm net losses increase the basis, for the purposes of determining gain or loss on the sale or other disposition of the asset to which they relate, there is no corresponding adjustment to take into account the disallowance attributable to allocating a portion of the taxpayer's expenses to that portion of the accelerated depreciation which has not been taken into income.

We believe that the failure to provide for a basis allocation in the case of a disallowance under Section 277 is inconsistent with the basis adjustment provided in the similar situation of disallowed tax preferences. Moreover, a failure to provide a similar adjustment in connection with amounts disallowed under Section 277, to the extent ordinary income is realized on a later sale of the property, will result in what we regard as unintended double taxation.

(b) Sections 84 and 277 - Adjustment for Interest on Debt Incurred to Carry Tax-free Obligations.

In both the Bill Section relating to the limitation on tax preferences and the Section relating to the allocation of deductions, tax exempt interest is treated as a net amount after reduction by the amount of any deductions for expenses applicable to tax exempt income which are disallowed under Section 265(a)(1). No reduction is provided, however, for interest on indebtedness incurred or continued to purchase or carry tax exempt obligations, which is disallowed as a deduction under Section 265(a)(2). We do not understand this distinction nor do we think that such a distinction is logical.

We recommend that both proposed Sections 84 and 277 be revised to define tax exempt interest as the net amount after reduction by both the amount of any deductions

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for expenses applicable to tax exempt income which are disallowed under Section 265(a)(1) and for interest on indebtedness incurred or continued to purchase or carry tax exempt obligations, which is disallowed as a deduction under Section 265(a)(2).

COMMENTS RELATING TO
SECTION 331 OF H.R. 13270

Section 1354(a) - Need to Aggregate All Deferred Compensation Payments.

While proposed Section 1354(a) provides a minimum tax on deferred compensation payments in excess of $10,000, it does not make it clear that deferred compensation payments from all sources received by an individual during any taxable year are to be aggregated, and that the minimum tax is to apply to the excess of the aggregate over $10,000. We suggest that the proposed section be adjusted to so provide.

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COMMENTS RELATING TO
SECTIONS 341 and 342 OF H.R. 13270

(a) Sections 665 through 669 - Effective Date Provisions and Burden of Compliance.

While we believe that the unlimited throwback rule is extraordinarliy complicated, and would make the administration of trusts accumulating income for perfectly legitimate family reasons extremely difficult, cumbersome, and expensive, we recognize that this is a broad question of tax policy, and will make no suggestions on the overall revision. However, the effective date provisions of Bill Section 341 seem objectionable in that they would operate retroactively with respect to income accumulated during the past five years when neither the trustee nor the beneficiary had any notice of the need to keep records by reason of a distribution of accumulated income which might be made at some further time, e.g., upon attaining majority of a beneficiary who now happens to be five years old.

It is suggested that the effective date provisions be modified, so that the new rules would apply only to transfers in trust made after the effective date of the Bill, or alternatively, that they would apply only to income accumulated after such date.

(b) Section 668(b)(2)(B) - Restriction on Use of "Exact" Method by Unborns.

The Bill provides that if a beneficiary was not yet born, with respect to a year to which part of the trust income which is distributed relates, the so-called "exact" method of computation may not be used. We see no reason why a beneficiary who was not alive for the entire period of accumulations cannot use the "exact" method at least with respect to those years during which he was alive.

We suggest that this discrimination be corrected.

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(c) Section 677 - Accumulations for Benefit of a Grantor Spouse.

In view of the unlimited throwback rule, it seems that this provision is of little significance. It is, therefore, questionable whether the complexities, which this provision may generate in situations where there is a lack of family harmony by taxing the husband on income payable to the wife, is justifiable.

In view of the proposal for the adoption of an unlimited throwback rule, it is suggested that the proposed amendment of Section 677 is not warranted.

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COMMENTS RELATING TO SECTIONS 411, 413 and 414 OF H.R. 13270

(a) Section 279(c)(2) - Use of Adjusted Basis of Assets in Ratio of Debt to Equity.

The ratio of debt to equity has long been used as an aid in determining whether certain securities were debt or equity. As pointed out in the Report of the House Committee on Ways and Means, the debt-equity structure of a corporation helps one decide whether it is reasonable to expect the corporation to meet its obligations to pay the principal and interest on the bond or debenture when due.

Proposed Section 279(c)(2) determines this ratio by valuing the assets at their adjusted basis. There seems to be little justification for using adjusted basis in an attempt to determine whether or not an issuer can make good.

We suggest that proposed Section 279(c)(2) be revised to change the valuation of assets in determining the debt-equity ratio from "adjusted basis" to fair market value.

(b) Section 279(f) - Definition of "Sources without the United States".

We suggest that, for purposes of clarity, proposed Section 279(f), containing an exemption in the case of certain acquisitions of foreign corporations where substantially all of the earnings of the acquired corporation for the three year period preceding the acquisition is from "sources without the United States", should contain a reference to the appropriate definition under Subchapter N.

(c) Section 1232(a)(3)(B) - Original Issue Discount in the Hands of Donees.

While this provision provides rules relating to the treatment of original issue discount by the purchaser

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of a bond, no such rules are provided for a donee or legatee.

We suggest that proposed Section 1232(a)(3)(B) be revised to determine any appropriate adjustment for previously included original issue discount in the hands of donees and legatees.

(d) Sections 6049(a)(1) and 6049(c) - Reporting Requirements.

The reporting requirements of this provision, as now written, are only relevant to the original holders of bonds with original issue discount. The reporting requirements do not take cognizance of the fact that subsequent owners will report as income amounts different than would an original owner.

We suggest that the reporting requirements be amended to reflect the fact that the payor corporation will report to the Service amounts which may be at variance with those which a subsequent holder will report as income.

(e) Section 249 - Clarification of "A Normal Call Premium".

Proposed Section 249 limits the premium deduction on the acquisition of an issuer's convertible indebtedness to "a normal call premium". However, the statute does not define what "a normal call premium" is.

We suggest that a definition of the term "a normal call premium" be added to proposed Section 249.

COMMENTS RELATING TO SECTION 421 OF H.R. 13270

(a) Section 305(b)(2) - Extent To Which Stock Dividends Shall Be Taxed.

The proposed statutory language, literally read, would tax the full amount of the stock distribution received by shareholders whose proportionate interests in assets or earnings and profits were increased, even though only part or even none of the stock distribution directly increases such proportionate interests. Thus, if a common stock dividend is distributed on one class of stock and both common stock and cash dividends are simultaneously distributed on another class of stock, not all of the stock distributed on the first class has the effect of increasing the recipient shareholders' proportionate interests in the assets or earnings and profits of the corporation. Another example would occur if a common on common dividend were distributed at the same time as a cash dividend on preferred stock, in which instance the common shareholders' interests in the net assets of the corporation might be considered to have been increased, not by reason of the distribution of common stock but rather by reason of the cash payment to the preferred shareholders. Presumably no tax on the common stock distribution is intended in such a situation.

We suggest that under proposed section 305(b)(2) stock dividends be treated as distributions of property to which section 301 applies only to the extent that the stock distribution itself causes an increase in the proportionate interests of the recipients.

(b) Section 305(b)(2) - Uncertain Meaning of "Proportionate Interests. . .In The Assets or Earnings and Profits".

Broadly speaking, the term "proportionate interests" may refer either to the relative interests of shareholders of different classes in the existing net assets of the corporation as of the moment of the distribution, or to the relative sizes of the potential claims which the shareholders of different classes may have against future assets or earnings of the corporation in the event of dividend or liquidating distributions.

If the former test is adopted (i.e., the relative interests of the shareholders in the earnings and profits or

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assets of the corporation on the date of the distribution), the question arises whether book values or fair market values of the corporation's assets are to control in making the necessary measurements. Additional problems may develop concerning the treatment of convertible securities or stock purchase rights in measuring proportionate interests.

If the proportionate interests in assets or earnings are to govern, it may be doubly difficult to determine the effect of convertible stock or stock rights, if the conversion or exercise price exceeds the current value of the subject stock. In such an instance, it may be uncertain at the time of the distribution whether there ever will be an alteration in the proportionate interests of shareholders. A corresponding problem could arise upon the distribution of a class of stock which participates in future earnings or liquidation proceeds only when such earnings or proceeds exceed certain levels.

In an effort to achieve greater certainty, we suggest that the test be based on proportionate interests in the corporation's assets (at fair market values) or earnings and profits as of the time of distribution instead of proportionate interests in potential assets or future earnings. We further recommend that in measuring such proportionate interests all conversion privileges and rights to purchase stock be deemed to be exercised unless the conversion or exercise price exceeds the fair market value of the subject security by more than 10%.

(c) Section 305(b) - Circular Treatment of Section 306 Stock.

Under existing section 306(c)(1)(A) the term "section 306 stock" includes stock received in a distribution, any part of which was not includible in gross income by reason of section 305(a). Under the proposed legislation, however, in order to determine whether a stock dividend is excluded from gross income under section 305(a), it may be necessary in applying the tests of section 305(b) to know whether the distributed stock is section 306 stock.

While it does not matter how this circle is broken from the standpoint of achieving certainty in application, it might be noted that taxation of dividends in preferred stock at the time of distribution under section 305(a) would render section 306 inoperative with respect to most of the distributions now covered by it. On the other hand, leaving such distributions in preferred stock untaxed under section 305 would create an anomolous situation where distributions of common stock might

be taxed under section 305 whereas simultaneous distributions of a "senior" preferred stock would not.

(d) Section 305(c).

This section is a broad authorization to the Treasury to prescribe Regulations under which certain changes in conversion ratio, changes in redemption price, and redemptions will be taxed as dividends to those stockholders whose proportionate interests in earnings and profits or assets are increased thereby.

The potential scope of the authorized Regulations is quite broad and could well exceed that which is necessary to cope with abuses of the type outlined in the House Committee Report. For example, the proposed statutory authorization would not only permit the Regulations to tax certain shareholders in connection with periodic redemption plans (which the House Committee Report suggests may have the effect of cash and stock dividends on different classes of stock), but also would seemingly permit taxation of a non-redeemed shareholder in some instances when another shareholder is redeemed in a "one-shot" realignment of the shareholdings in the corporation. The harshness of the tax result in this and other redemption situations is accentuated in cases where shares have been redeemed for an amount equal to or exceeding their pro rata share of the value of the corporation's net assets, so that the remaining shareholders have either not increased, or have suffered a decrease in, the value of their holdings, even though their proportionate interests in the corporation have increased.

Similarly, whereas annual changes in the conversion ratio or redemption price of a security might indicate a disguised stock dividend, convertible preferred stock may be issued under terms providing for only one or two conversion changes or changes in redemption price during the life of the stock, these changes being designed to encourage conversions at an early date with the objective of simplifying the corporation's capital structure. It is doubtful that the proposed legislation is intended to tax such changes as dividends to the shareholders whose interests may be favorably affected thereby.

We suggest that the proposed legislation, or at a minimum the Senate Finance Committee Report, more clearly delineate the scope of the new rules. Thus, in connection with stock redemptions section 305 may be limited to redemptions

pursuant to periodic redemption plans or redemptions involving 10% or less of the shareholdings of the redeemed stockholders. Provisions for changes in conversion ratios or redemption price designed to have the effect of disguised dividends should be distinguished from similar provisions designed with other goals in mind.

(e) Section 317(a).

The proposed amendment to section 317(a)(and a corresponding change in section 305(a)) was intended to cause all stock dividends on preferred stock to be taxable. The Report prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance (August 18, 1969), at page 63, indicates that an exception was intended to this rule to permit anti-dilution distributions on convertible preferred stock to be received tax-free. The proposed statutory language should be altered to admit such an exception.

(f) Effective Date Provisions - Unfairness of January 10, 1969 Effective Date.

Despite the promulgation on January 10, 1969 of Treasury Regulations providing in substance for several of the proposals embodied in the House Bill, it is quite possible in view of the controversial nature of portions of these Regulations that distributions may have been made after January 10 which would have been taxable under the Regulations but which were made with the conviction that the Regulations were broader than permitted by the statute. Moreover, the January 10, 1969 Regulations do not appear to correspond in all respects to the proposals in the House Bill. Since there is substantial doubt as to the interpretation, scope and even validity of certain provisions of the January 10, 1969 Regulations, it seems unduly harsh to make the effective date of any provisions of the proposed legislation retroactive to that date.

COMMENTS RELATING TO
SECTIONS 431, 432 and 452 OF H.R. 13270

(a) Section 904(a) - Violation of Treaty Law.

In requiring an adjustment of the foreign tax credit limitation, in a year where income is derived from a country in which a loss was previously incurred, the drafters of the Bill apparently overlooked the fact that the proposed amendment may well violate many tax conventions with foreign countries. In most of the tax conventions, the United States had consented to give credit for the taxes imposed by the other state. As a matter of treaty law, the credit to be given is based upon the Revenue Act in force at the time the tax convention becomes effective.

The proposed amendment would result, under certain circumstances, in a unilateral abrogation of United States treaties, an unintended result that the Senate Finance Committee should be made cognizant of.

(b) Section 904(g) - Effect in Civil Law Countries.

We believe that the House of Representatives, in approving Section 432 of the Bill, designed to place a limitation on the foreign tax credit paid on "foreign mineral income", was not aware of the scope of the change they were making. The apparent reason for the Bill was that certain foreign income taxes imposed on mineral income should be considered royalties and should not give rise to foreign tax credit. However, under civil law, which law governs most of the countries of the world, mineral rights are owned or controlled by the sovereign. Since proposed Section 904(g) would limit the foreign tax credit if a foreign government holds substantial mineral rights with respect to the property, the amendment may well deny substantial credits to United States companies even though there is no royalty incurred in the foreign taxes paid.

We believe that this amendment represents an unwarranted discrimination against a certain class of foreign income and should be deleted.

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(c) Section 312(m) - Effect of the Change in Earnings and Profits on Foreign Source Income.

The proposed amendment of Section 315 of the Code, to provide for the computation of earnings and profits based on straight line depreciation has an unusual and unintended effect, we think, on the taxation of income derived by United States taxpayers from foreign sources. If the computation of the earnings and profits of a foreign company, required under present Section 902 of the Code, are modified by proposed Section 312, the following unintended changes will take place in the amount allowable as foreign tax credits. For example:

1. Foreign tax credits will decrease as foreign earnings and profits increase;

2. United States shareholders witn subpart F income may have income which they would not otherwise have attributed to them;

3. Domestic corporations with subpart F income would have increased income and decreased tax credits; and

4. "Greater" minimum distributions will be required of subpart F income.

It is suggested that the amendment of Section 312 be reconsidered in the light of its effect on subpart F income and the amounts of foreign tax credits allowed, and if the results mentioned above are not intended, proposed Section 312(m) should specify that it is inapplicable to foreign companies.

COMMENTS RELATING TO
SECTION 461 OF H.R. 13270

Section 1201(a) - Need to Clarify Effective Date.

Bill Section 461(c) indicates that the amendment increasing the corporate capital gain rate from 25% to 30% is intended to apply to "sales and other dispositions after July 31, 1969". Assuming that the aforesaid language refers to the transaction and not the accounting method (or other method of reporting) which governs, it is too broad and at best is open to various interpretations. For example, are payments received pursuant to an installment sale made before July 31, 1969, taxable at 25% even though the payments are received after July 31, 1969.

The Bill should be amended to make it clear whether July 31, 1969 is supposed to be a cut-off date only as to an actual "sale" or "other disposition" made after that date, or is intended to apply to any gain recognized after that date, even if attributable to a sale or other disposition prior to August 1, 1969.

Moreover, we think the effective date language should be amended to clarify the fact that the date is a cut-off date as to all transactions which are not, strictly speaking, a sale or exchange but which necessitate the recognition of capital gain - e.g., liquidation distributions.

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COMMENTS RELATING TO
SECTIONS 511 AND 515 OF H.R. 13270

(a) Section 1201 - Need for Standards Regarding 1969 Allocation.

Bill Section 511(c) provides that for taxable years beginning before and ending after July 25, 1969, the alternative tax shall be computed in a manner prescribed by the Secretary of the Treasury or his delegate. In the absence of some congressional standards to be applied to the transitional year, we believe that this delegation to the Secretary of the Treasury to prescribe rules is an improper delegation of authority. In acting pursuant to the aforesaid delegation, the Secretary or his delegate may be promulgating substantive rules rather than interpreting congressional language.

We recommend that the Bill be amended to provide substantive language to deal with the computation of the capital gains tax in the transitional year.

(b) Section 402(a) and 403(a)(2) - Use of the Term "Benefits Accrued".

Both proposed Section 402(a)(5) pertaining to distributions from qualified trusts and proposed Section 403(a)(2)(C) pertaining to qualified annuity plans use the phrase "benefits accrued" as of a cut-off date in connection with the determination of that portion of a distributee's account which will retain capital gain status on distribution.

We submit that the phrase "benefits accrued" is ambiguous when used for plans other than a profit-sharing plan or a money purchase pension plan. In an ordinary pension plan, a layman might think the term referred to the cash sum then held under the method of funding utilized by the particular plan, but to benefit planners and actuaries, the term normally refers to a hypothetical amount which ought to have been funded by the date in question, depending upon the method of funding, varying from a complete deposit of the total amount necessary to provide the pension in

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advance, to no deposit at all, but rather a mere current pay-out of pension benefits. For this reason, it is suggested that the term "benefits accrued" be clarified.

One suggested solution is to define "benefits accrued" in terms of one or more of the funding methods which contemplate level costs or payments for the entire working career of the employee, whether or not the monies have actually been deposited. The alternative solution of according the relief simply to assets on hand at the cut-off date, appears to us unfair since the result to the employee would largely depend upon the funding method selected by his employer.

COMMENTS RELATING TO
SECTION 521 OF H.R. 13270

(a) Section 167(k) - Definition of "low-cost rental housing".

The proposed new subsection (k) to be added to Section 167 (relating to depreciation) provides for accelerated depreciation of rehabilitation expenditures in connection with "low-cost rental housing". The definition of "low-cost rental housing" contained in Section 167(k) (3)(B) refers to dwelling uints held for occupancy on a rental basis by families of "low or moderate income, as determined by the Secretary or his delegate in a manner consistent with the policies of the Housing and Urban Development Act of 1968". The Housing and Urban Development Act of 1968 and predecessor acts have used the terms "low income", "lower income" and "low or moderate income" for various special programs. The term "low or moderate income" does not appear in earlier Housing and Urban Development legislation. For these reasons, it is submitted that the definition of "low-cost rental housing" proposed for purposes of the special depreciation deductions to be allowed in the case of rehabilitation expenditures is inadequate.

The term should not be so vaguely defined in the statute as to leave the Secretary of the Treasury with the responsibility of determining the policies of the Department of Housing and Urban Development. This definition should be made more precise after consulting with the staff of the Subcommittee on Housing and Urban Affairs and representatives of the Department of Housing and Urban Development.

(b) Section 167 - Need for Redesignations of Subsections.

Bill Section 521(a) amends Section 167 of the Code by redesignating subsection (j) as subsection (n) and by inserting after subsection (i) new subsections (j) and (k). This would leave the lettering of subsections to run from (a) through (n) without any subsections (l) or (m).

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Neither the Committee Report nor the Bill make reference to the fact that new subsections (l) and (m) are proposed to be added to Section 167 by Sections 451 and 705 of H.R. 13270 respectively. This may cause technical difficulties if Section 521 is retained in tact and Sections 451 and 705 (or either of them) are rejected before final passage.

This should be corrected by adding at the end of line 7, page 300 of H.R. 13270 the following: "to follow subsection (m) (added by Section 705)".

(c) Section 167(j)(3) - Reference to Present Section 48(h).

Proposed Section 167(j)(3) contains a provision for the adoption of regulations "similar to the rules provided in paragraphs (5), (9), (10) and (13) of Section 48(h)",to be applied for purposes of that paragraph which excludes property from the new depreciation rules where construction was begun or a binding contract for construction was entered into before July 25, 1969. Paragraphs (5), (9), (10) and (13) of Section 48(h) contain transition rules for plant facilities, certain disregarded transfers (principally transfers where the basis of the property carries over to the transferee), property acquired from affiliated corporations and certain replacement property, all of which applied in the case of the suspension of the investment credit.

Although the reference to rules provided in paragraphs (5), (9), (10) and (13) of Section 48(h) may be effective to accomplish the purpose intended, we think it would be clearer if the reference to Section 48(h) included paragraph (4) which relates to an equipped building rule, in addition to paragraph (5) relating to the plant facility rule.

(d) Section 381(c)(6) - Failure to Carry Over Transferor's 150 Percent Declining Balance Depreciation Method on Used Property.

The proposed amendments to Sections 167 and 381 result in the clearly unintended result of prohibiting

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the carryover of depreciation methods in the case of <u>used</u> property, (a) acquired by a taxpayer prior to July 25, 1969; and (b) transferred after July 24, 1969 in a transaction falling within Section 381(a) of the Code.

This result occurs because proposed Section 381 (c)(6), which allows the carryover of depreciation methods in transactions falling within Section 381(a), permits the carryover of only those depreciation methods specified in paragraphs (2), (3) and (4) of Section 167(b) and in proposed subsections (j)(1), (k) and (m) of Section 167.

1. Sections 167(b)(2), (3) and (4), which permit the use of the double declining balance method, the sum of the years' digits method and any other no more rapid method, are restricted by Section 167(c) to new property acquired after December 31, 1953; it does not apply to property purchased used and, therefore, is inapplicable to the situation to which we are referring.

2. Proposed Section 167(j)(1), read in conjunction with Section 167(j)(3), is only applicable to property acquired under specified circumstances after July 24, 1969.

3. Proposed Sections 167(k) and 167(m) have no relevance at all to the problem we are discussing.

Therefore, unless there is a specific provision in Section 381(c)(6) providing for the carryover of the 150 percent declining balance method on used property acquired prior to July 25, 1969, the transferee corporation, in a tax-free reorganization or liquidation, will be restricted to the straight line method of depreciation, as specifically required in proposed Section 167(j)(4). We believe that the clear intention of proposed Section 381(c)(6) was to permit the carryover of <u>all</u> depreciation methods in a transaction covered by Section 381(a). The Section as presently written fails to accomplish this result because it fails to take into account the fact that up to the present time, the ability of a taxpayer to use the 150 percent declining balance method on used property was based solely on provisions in the Treasury Regulations and not on anything specifically in the Code.

Since taxpayers have consistently been allowed, prior to the proposal in Section 167(j)(4), to depreciate used property by the 150 declining balance method, heretofore there has been no need to provide for the carryover of this method in tax-free transactions; with the passage of proposed Section 167(j)(4), there will be such a need. We suggest that proposed Section 381(c)(6) be revised to specifically provide for the carryover of the 150 percent declining balance method of depreciation in the case of used property acquired before July 25, 1969 and transferred in a tax-free transaction to which Section 381(a) applies after July 24, 1969.

COMMENTS RELATING TO
SECTIONS 601 and 602 OF H.R. 13270

(a) Section 103(b)(1) - Subsidies for Industrial Development Bonds.

The election given to States and their political subdivisions to elect to issue taxable bonds can be made with respect to certain industrial development bonds which remain tax exempt under Section 103(c), such as certain small issues. It is unclear why the United States should pay any subsidy to a lending institution for such loans. Furthermore, the ultimate user of the funds would pay less interest because of the incentive factor prescribed by Section 103(b) if, in fact, the election is made.

We recommend that Section 103(b)(1) be revised to insure that no election may be made with respect to industrial development bonds which remain tax exempt.

(b) Section 103(b)(2) - Irrevocability of an Election.

This provision does not make it clear whether an election with respect to an issue which is withdrawn would be irrevocable if the issue is placed on the market at a later date.

We recommend that Section 103(b)(2) be revised to specify that an election with respect to any issue once made is irrevocable except with respect to any issue not actually issued.

(c) Section 103(b)(2) - Failure of Secretary to Recognize a Purported Election.

It is unclear what consequences would follow from a failure of the Secretary to recognize a purported election under this section.

We suggest that Section 103(b)(2) be revised to provide that an election is effective only upon certification by the Secretary or his delegate.

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(d) Section 103(d) - Definition of Arbitrage Operation.

The term "arbitrage operation" is not defined in the Bill, notwithstanding the fact that interest on such obligations issued after July 11, 1969 is taxable. Thus, taxpayers bear the risk of paying taxes on obligations they presently consider tax exempt but are subsequently found to be taxable. Furthermore, taxpayers run the risk of relying on the stated intention of a state with respect to newly issued obligations.

To avoid unfair consequences to a taxpayer, Section 103(d) should be revised to provide that an obligation will be considered an "arbitrage obligation" only from the date it is so designated by the Secretary or his delegate, and only interest either paid or accruing after that date will be considered taxable.

(e) Section 602(b)(1) - Determination of Fixed Percentage.

Under this Section, the Secretary or his delegate must determine and pay a fixed percentage of the interest yield on each issue of obligations to which an election under Section 103(b) applies. If the Secretary or his delegate does not determine the percentage for calendar quarters substantially before the first day of the quarter, an issuer would be uncertain as to the applicable percentage and would have insufficient planning time.

We recommend that Section 602(b)(1) be revised to provide that the Secretary or his delegate shall determine the applicable fixed percentage before the first day of the month preceding each calendar quarter.

(f) Section 602(b)(1) - Issues Sold in Subsequent Quarters.

The Bill provides that the fixed percentage determined by the Secretary or his delegate shall apply with respect to all issues of obligation made during the calendar quarter to which elections under Section 103(b) apply. What is the applicable percentage with respect

to obligations actually issued or sold in a quarter subsequent to the quarter in which the initial obligation in an issue are issued or sold? How will an issuer be able to plan an issue if it cannot be completed in one quarter?

We recommend that these questions be answered by revising the last sentence of Section 602(b)(1) to read as follows:

> "The fixed percentage so determined and published shall apply with respect to any obligation issued as part of an issue, the initial obligations of which are issued during such calendar quarter and to which elections under such Section 103(b) apply."

(g) Section 602(c) - Administrative Burden of United States.

Although the General Explanation of the House Committee on Ways and Means specifies on page 174 that, "in no case will the United States be required to assume the administrative burden of making payment directly to the holders of the obligations", proposed Section 602(c) does not specifically so provide.

A subsection should be added to Section 602 to specifically provide that payment by the United States shall be made directly to the state or the paying agent designated by the state.

COMMENTS RELATING TO
SECTION 703 OF H.R. 13270

(a) Section 49(b)(5) - Sale and lease-back transactions.

It seems clear under the Bill that the investment credit can be passed through to a lessee if the lessor purchased the "asset" from the lessee after April 18, 1969, provided the lessee in the sale and lease-back transaction had a binding contract preceding that date. Considering the literal reading of the language contained in Section 48(d) of the existing law, it is not clear that a pass-through of the credit is permitted where the lessor purchases from the lessee the binding contract, and the lessor thereafter acquires the asset from the supplier. To eliminate the possible ambiguity, language should be inserted at the conclusion of Section 49(b)(5) to the effect that "in any case in which a lessor described in this paragraph makes an election under Section 48(b), the lessee described in this paragraph shall be treated as having acquired pre-termination property."

The Bill is also not consistent in permitting taxpayers similarly situated to enter into sale and lease-back transactions following April 18, 1969 where the seller in the sale and lease-back transaction has the right to claim the investment credit. If the seller in a sale and lease-back transaction were the purchaser of the asset pursuant to a binding contract predating April 18, 1969, the purchaser in a sale and lease-back transaction would be entitled to claim the investment credit. If the seller, on the other hand, was entitled to the investment credit because it or its subsidiary was the manufacturer of the asset and was entitled to the investment credit because it met the machinery and equipment rule (Section 49(b)(4) of the Bill), the purchaser in a sale and lease-back transaction would not be entitled to claim the investment credit. That inconsistency in treatment has no justification and to correct it Section 49(b)(5) should be revised to read as follows (including the language required to eliminate the ambiguity referred to above)--the proposed changes in language being designated by the underlining of the appropriate words in the following quotation:

"(5) Certain Lease-Back Transaction, Etc.--
where a person who is--

"O"

"(i) a party to a binding contract described in paragraph (1) transfers rights in such contract (or in the property to which such contract relats), or

"(ii) a taxpayer referred to in paragraph (4) transfers a piece of machinery or equipment referred to in paragraph (4)

to another person but a party to such contract or a taxpayer referred to in paragraph (4) retains a right to use the property under a lease with such other person, then to the extent of the transferred rights such other person shall, for purposes of paragraphs 1 or (4) succeed to the position of the transferor with respect to such binding contract and such property. In any case in which the lessor does not make an election under Section 48(b)--

"(A) the preceding sentence shall apply only if a party to the contract or a taxpayer referred to in paragraph (4) retains the right to use the property under a lease for a term of at least one year; and

"(B) if such use is retained, the lessor shall be deemed for the purpose of Section 47 as having made a disposition of the property at such time as the lessee loses the right to use the property.

"For purposes of subparagraph (B), if the lessee transfers the lease in a transfer described in paragraph (7), the lessee shall be considered as having the right to use the property so long as the transferee has such use. In any case in which a lessor described in this paragraph makes an election under Section 48(b), the lessee described in this paragraph shall be treated as having acquired pre-termination property."

Statement By Edwin M. Hood, President
Shipbuilders Council of America
Washington, D.C.

In Connection With HR-13270
The Tax Reform Act of 1969

September 24, 1969

I. PROPOSED AMENDMENTS TO THE TAX REFORM BILL OF 1969

The Shipbuilders Council of America, composed of major shipbuilding companies and allied suppliers in all sections of the United States, proposes amendments to HR-13270 (the Tax Reform Act of 1969) to accomplish the following:

(1) A 15 percent write-off between contract and delivery dates of new vessels.

(2) A ten-year ship life for tax purposes.

(3) A special additional depreciation allowance of 30 percent for the first five years after delivery of a new ship.

(4) Tax exemption of the proceeds of ship sales reinvested in new ships.

(5) A tax deduction for lenders of a percentage of interest, leasing and charter income from new ships.

For an evaluation of the merit of these techniques, there is attached as Appendix A a paper entitled "Investment Incentives for the Maritime Industry" prepared by Dr. Jacob J. Kaplan of Washington, D.C., an independent consultant on international finance and economics.

II. WHY THE PROPOSED AMENDMENTS ARE NECESSARY

All of the reasons compelling adoption of the above proposed amendments to HR-13270 are variations of one central theme - the

present United States Merchant Marine desperately needs incentives for investment in new United States flag vessels. Because of inadequate financing, levels of ship construction in the past decade have failed to offset the impediments of age and inefficiency which have plagued the nation's shipping fleet.

The United States Merchant Marine is largely comprised of vessels that are obsolete - 85 percent of the combined government-owned and privately-owned fleet today registered under the American-flag is 20 years of age and older. What newer investment there has been, over the past decade, relates primarily to vessels built through governmental subsidies, representing substantial cost to the government but applying to less than one-third the present fleet.

These statistics simply confirm that if maintenance of the United States Merchant Marine is of national importance - and there is virtually no debate on this point - private investment has not been sufficiently attracted. Some alternative approach - to stimulate private investment - is obviously in order, and the proposed amendments are designed to provide that stimulus.

The obsolescence and decline of the American Merchant Marine is further illustrated by the fact that only 6.5 percent of United States oceanborne foreign trade was carried on U.S. flag vessels in 1967. When this figure is compared with the goal of The Merchant Marine Act of 1936 that the United States fleet carry 30% of the nation's foreign trade and with the 1950 performance in which 39 percent of the nation's

foreign trade tonnage was transported on United States bottoms, the need for providing incentives for private investment in domestic built vessels becomes dramatically apparent.

From its position as the world's greatest shipbuilding nation at the end of World War II, the United States has slipped to 12th place in terms of annual commercial tonnage constructed. The American-flag merchant fleet, which at the end of World War II was the largest in the world, now ranks fifth and will plummet further in global standing in the years ahead unless corrective incentives are instituted promptly.

Since 1946, American owners or their affiliated corporations have purchased approximately 1,650 new foreign built merchant vessels of nearly 35,700,000 dwt. to be sailed under "flags of convenience" or other foreign registry. During the same period, only 484 commercial vessels of approximately 7,800,000 dwt. have been built in United States shipyards to be sailed under the United States flag.

In these times of sharply increasing international trade and tensions, the United States has become dangerously dependent upon foreign-flag vessels built in foreign yards and manned with foreign crews for import and export, as well as for defense purposes. An additional consequence of this situation is the adverse effect upon the nation's balance of payments deficit. The combination of United States companies' purchases of foreign built vessels (estimated to have totalled between \$5 billion and \$8 billion since 1946), wage payments to foreign crews plus United States manufacturers' and retailers'

shipping payments to foreign shippers add up to a very heavy drain on the United States balance of payments.

The decrease in the United States Merchant Marine is of extreme national importance. President Nixon has stated the need for "the restoration of the United States as a first-rate maritime power." In view of the essentiality of a sound U.S. shipping fleet, and in view of the drastic need for its improvement, the construction of ships in U.S. shipyards for commercial operation under the United States-flag must be stimulated. This is not the time to remove incentives for private investment in new U.S. vessels, yet HR-13270 in its present form would eliminate the investment tax credit with respect to oceangoing vessels.

III. GENERAL EXPLANATION OF PROPOSALS

The Shipbuilders Council of America submits that, given adequate economic incentives, United States private enterprise can significantly contribute to an improvement in the Merchant Marine situation so as to enable decreasing direct outlays on the part of the Federal Government. The Council believes that tax incentives can help provide a favorable shipbuilding climate at less cost than direct subsidies with their dependence on annual appropriations and limitations to only a part of the American fleet.

Although the investment tax credit has not been sufficient alone to solve the maritime problem, some enterprising United States ship-

builders and operators have used the investment tax credit for construction of vessels that might otherwise have been built overseas. Its loss would further hinder a nation seeking to re-establish itself as a first-rate maritime power within the framework of the free enterprise system.

The Shipbuilders Council of America submits that national interest and national security are vitally affected by the status of the United States Merchant Marine, and hence requires urgent attention, sufficient stimulii and adequate incentives.

IV. TECHNICAL EXPLANATION OF PROPOSALS

As demonstrated in Dr. Kaplan's report, the Shipbuilders Council of America recommends incorporation into HR-13270 of the following alternative tax incentives for investment in a sound United States Merchant Marine:

1. The purchaser of an oceangoing vessel constructed or reconstructed in a United States shipyard shall be entitled to commence depreciating the vessel upon entering a binding shipbuilding contract. The depreciation allowable during the construction period (commencing with execution of the shipbuilding contract and ending with delivery of the vessel) shall be limited to 15 percent of the vessel's contract price. The completed vessel's cost basis for regular depreciation purposes shall be reduced by the amount of such depreciation. This special depreciation deduction should be available only with respect to vessels which are not the subject of a construction differential subsidy, thus

providing an economic incentive for a ship operator to forego obtaining direct governmental subsidy.

2. The owner of an oceangoing vessel which is constructed or reconstructed in a United States shipyard and which is not the subject of a construction differential subsidy shall be permitted to amortize the cost of the vessel over a ten-year period. This provision would be compatible with Section 705 of HR-13270, permitting accelerated amortization of railroad cars, on the basis that the national interest will be served by similar treatment for oceangoing vessels. The exclusion of vessels subject to a construction differential subsidy is, of course, for the purpose of encouraging operators to forego direct governmental subsidy.

3. The owner of an oceangoing vessel constructed or reconstructed in a United States shipyard shall be entitled to an additional depreciation allowance of up to 30 percent of the vessel's cost during the first five years of its operation. Such depreciation shall be in addition to the depreciation otherwise allowable, in the same manner as additional first year depreciation is presently allowed for small business under Section 179 of the Internal Revenue Code. The taxpayer-owner shall be entitled to elect in each of the first five years to take any amount of such additional depreciation, but the amount claimed in any one year shall not exceed 10 percent of the vessel's cost. The additional first year depreciation shall be limited to vessels which are not the subject of a construction differential subsidy,

as previously described.

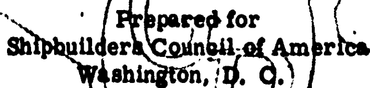
4. Any gain on the sale of an oceangoing vessel shall not be recognized for tax purposes if, within a period beginning one year before the sale and ending one year after the sale, the taxpayer enters a contract to acquire a newly constructed or reconstructed oceangoing vessel. The nonrecognition of gain shall apply much in the manner that Section 1034 of the Internal Revenue Code presently provides for nonrecognition of gain on the sale or exchange of a residence, thus requiring the new vessel's purchase price exceed the old vessel's sales price for complete nonrecognition. The nonrecognition shall, of course, apply to defer recognition of depreciation recapture (under Section 1245 of the Internal Revenue Code) as well as capital gain. As with respect to sale or exchange of a residence under Section 1034, the cost basis of the newly acquired vessel shall be reduced by the amount of gain deferred. Similarly, the amount of depreciation recapture deferred upon sale of the old vessel shall be carried over until sale of the new vessel (or a succeeding vessel) results in a recognized gain. As in the previously suggested provisions, this nonrecognition of gain shall apply only if the newly constructed vessel is not the subject of a construction differential subsidy.

5. Financial institutions shall be entitled to except from their interest income an amount equal to 10 percent of the interest received under construction and mortgage loans with respect to oceangoing

vessels constructed or reconstructed in a United States shipyard. Similarly, recognizing that financing institutions and others will in some cases actually take ownership of vessels and charter them to operators in order to finance the operators' use of the vessels, such institutions and others shall be entitled to exempt from gross income an equivalent portion of the charter hire as it is received. The exemption of both interest and charter income shall, as previously described, apply only with respect to vessels which are not the subject of a construction differential subsidy. This provision would conform to the deduction for interest upon residential real property loans, student loans and other loans in the national interest, as recommended by Assistant Secretary of the Treasury Cohen before the Senate Finance Committee on September 4, 1969.

APPENDIX A

INVESTMENT INCENTIVES FOR THE MARITIME INDUSTRY



Prepared for
Shipbuilders Council of America
Washington, D. C.

September 1969

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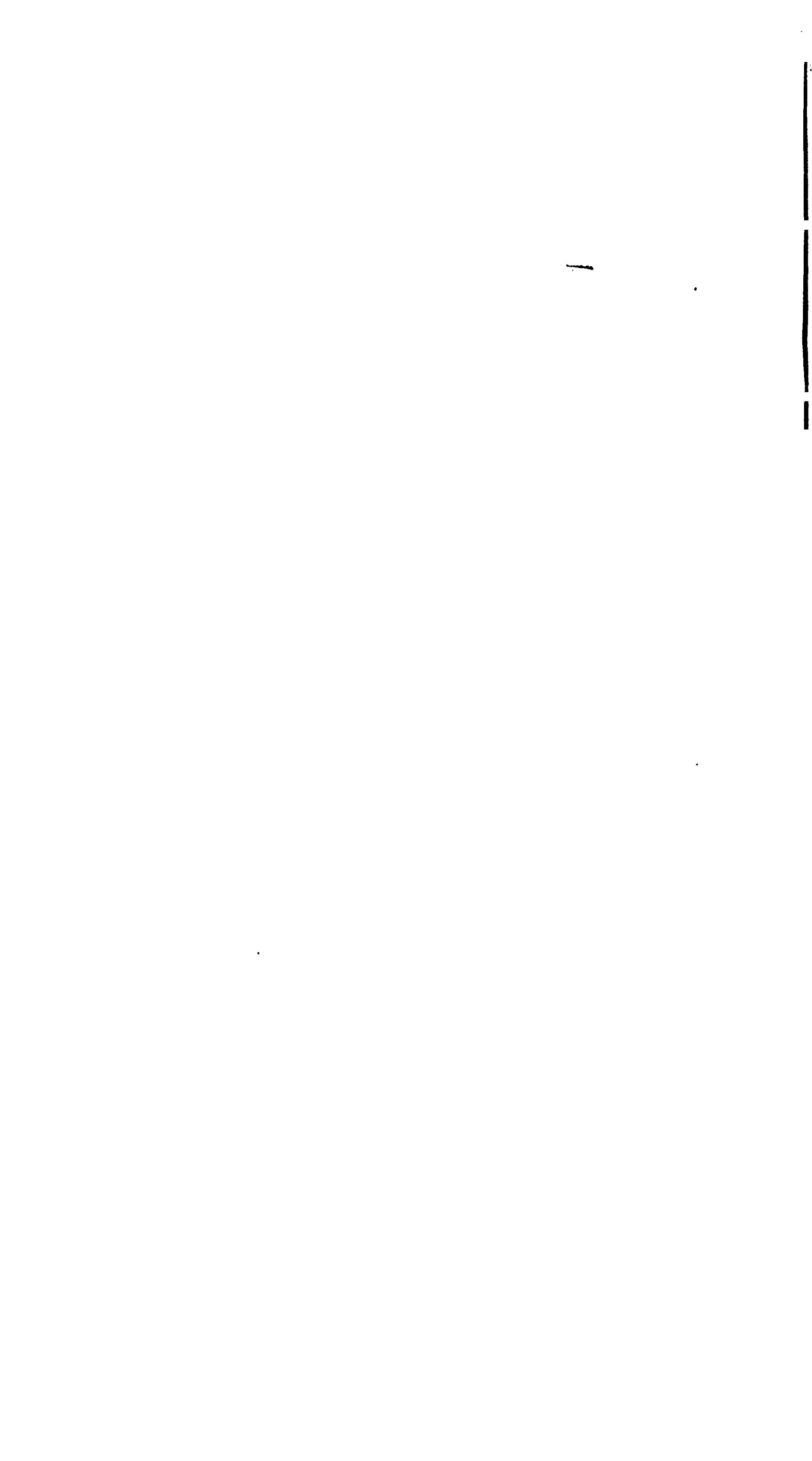

SUMMARY

The obsolescence of the U. S. merchant marine has proceeded to the point where major decisions can no longer be deferred by the U. S. government. For at least a decade, other pressing concerns have been given priority while policy makers took some comfort from the continued existence of a large fleet of ships built during World War II. With the passage of a quarter of a century since they were built, such vessels cannot be counted upon any longer for reliable carriage of goods in international trade. They have, of course, long passed the point of competitiveness. Other countries have taken advantage of advances in marine technology and ship size to increase and modernize their fleets with newer and much more efficient vessels.

U. S. flag ships carried 6.5 percent of U. S. oceanborne foreign trade in 1967, a steady and persistent decline from the 39 percent level of 1950. The number of new merchant vessels completed in U. S. yards averaged 15 per year over the last five calendar years. Even these low levels of U. S. shipbuilding and U. S. participation in the carriage of its overseas trade required substantial U. S. government budgetary expenditures. Such charges on the federal budget stem from higher wages and other costs prevailing in the United States. However, they also result from the operation of economically obsolete vessels and the low volume of merchant ship construction in U. S. yards.

The present inadequacy of the U. S. merchant marine - and the prospect of continued deterioration - involves increased national security risks and reduced options for the U. S. government in dealing with emergency situations that may arise. In recent years, the Soviet Union has placed a very high priority on the expansion and modernization of its merchant fleet.

A significant contribution to correction of the U. S. balance of payments problem would be made if the U. S. merchant marine was expanded and if owners turned to U. S. shipyards rather than buying vessels abroad for operation under U. S. and foreign flags. The purchase of ships by U. S. nationals from foreign yards involves large and increasing sums of foreign exchange. Without appropriate incentives for investment in U. S. built ships, the U. S. balance of payments will suffer significant further damage.

Investment incentive techniques have been very effective in other industrialized countries that boast of much younger and more competitive merchant marines. The following techniques should be considered for application in the U. S.:

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- (1) A 15 percent write-off between the contract and delivery dates of new vessels.
- (2) A ten-year ship life for tax purposes.
- (3) A special additional depreciation allowance of 30 percent for the first five years after delivery of a new ship.
- (4) Tax exemption of the proceeds of ship sales reinvested in new ships.
- (5) A tax deduction for lenders of a percentage of interest, leasing and charter income from new ships.

BLOCK OBSOLESCENCE OF THE U. S. MERCHANT MARINE CAN NO LONGER BE IGNORED

The Merchant Marine Act of 1936 confirmed the statutory life of vessels at 20 years, a reasonable estimate of the economic life of ocean-going ships under then prevailing conditions. Amendments to the Act in 1960 extended that life to 25 years for vessels other than tankers and other liquid bulk carriers. The amendments reflected physical longevity rather than the rate of economic obsolescence. Internal Revenue Service guidelines on depreciation for tax purposes suggest 18 years for ships.

Actually, the rate of technological advance in shipping has been much accelerated during the 1960's. Larger and faster ships with more sophisticated equipment offer important economies so that the more competitive fleets have been rapidly replacing older tonnage. With wage rates rising rapidly in all industrialized countries, the incentive to take advantage of further advances in ship technology remains high. For such countries, the economic life of vessels that must operate under international competitive conditions is unlikely to exceed ten years and may well be much less.

The U. S. Fleet is Strikingly Overage

On September 30, 1946, the U. S. merchant marine consisted of 4,852 vessels, [1/] most of them built during World War II for government account. Only 2,332 of these ships were then active in foreign and domestic trade. The very size of the inactive fleet minimized the national security requirement for building additional ships in the post-war years, whatever the economies offered by newer vessels.

By the end of 1966, however, the U. S. merchant marine had fallen to 2,278 vessels. Of this total, 1,313 were government-owned, with an average age of 23 years. [2/]

1/ Maritime Administration, Employment Report, June 1968.

2/ Maritime Administration, A Statistical Analysis of the World's Merchant Fleets, December 1966.

By mid-1969, the last of the inactive ships that were desirable for reconversion had been sold to private operators. On July 1, 1969, only 1,050 ships [1/] remained under government ownership, a third of them classified by the Maritime Administration as "scrap." Only 72 out of 172 ships activated to meet Vietnam requirements remained in full operating status. In another five years, the reserve fleet will have few, if any, World War II vintage vessels that can be depended upon.

As for the privately-owned U. S. flag fleet, it numbered 965 ships at the end of 1966, with an average age of 19 years. Despite sales from the government-owned fleet and some new construction, the privately-owned fleet numbered 963 ships on July 1, 1969.

The dry bulk carrier segment of the fleet is in particularly bad shape. Not only had the number of such ships declined to 53 by mid-1968, [2/] but their average age at that time was 24 years. Time has run out, even on the statutory life decreed for subsidized ships by the 1960 amendments.

The privately-owned freighter and tanker fleets are not much younger. Two-and-a-half years ago, their average age was 19 years and 17 years respectively.

The Older Ships are Inefficient and Cannot Compete with Newer Vessels

They are generally smaller and slower than ships built in recent years. They suffer more breakdowns and need more repairs. Insurers are seeking higher premiums for aged vessels. Rising living

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1/ Maritime Administration, Merchant Marine Data Sheet, July 1, 1969.

2/ Fernley and Eggers Chartering Co., Ltd., quoted by Booz Allen Applied Research, Inc., The National Need for a Dry Bulk Fleet, February 1969.

standards and wages put a premium on the efficient use of labor. Ships now being ordered on the world market carry several times the cargo of vessels built in the 1940's, frequently at manning levels below that of older ships. Four tankers are now being built for the U. S. flag fleet with a deadweight tonnage of 35,000 and a manning level of 23 that seems to be acceptable to the unions. The much smaller tankers built ten or 20 years ago have crews twice as large. Orders for 120,000-ton tankers have recently been placed in U. S. yards. While no manning level has been announced for these ships, it could well approximate that for the 35,000-ton vessels.

U. S. wage levels present a formidable obstacle to the operation of ships with U. S. crews in competition with those manned by nationals of lower wage countries. Nevertheless, the container ship experience demonstrates that U. S. operators who are able to move to the forefront in applying modern ship technology may be able to face such competition successfully and profitably, at least for part of the traffic.

The situation of the dry bulk cargo operators demonstrates the results of trying to operate highly obsolete vessels under the U. S. flag. Their ships are able to compete only for U. S. government sponsored cargoes that must be carried on U. S. flag ships. Last year charter rates for such vessels to carry grain from the U. S. Gulf to India ran as much as $29 per ton. For the same cargo and voyage, rates of $12 a ton were fixed for internationally competitive cargoes. A recent study estimated that a new 40,000 ton vessel built in U. S. yards without subsidy and using U. S. crews could carry such cargo profitably at $16 per ton. [1/]

1/ Booz Allen and Hamilton, Inc., Alternative Financing Methods for a Dry Bulk Ship Program, May 1969, p. 20.

Competitor Fleets are Much Younger on the Average

The U. S. merchant fleet is about twice as old, on the average, as the fleets of other industrialized countries. The data in Table No. I reflect the situation as of the end of 1966, the latest date for which complete data are readily available. In the interim, the other countries listed have received delivery on a large number of new vessels, so that the disparity between the average age of their fleets and ours has increased. The order books suggest that the disparity will continue to increase over the next few years, no matter how promptly the U. S. begins the renovation of its merchant marine.

TABLE NO. I

MERCHANT FLEETS OF INDUSTRIALIZED COUNTRIES
Number and Age, end of 1966

Country	Total No.	Total Ave. Age (years)	Freighters No.	Freighters Age	Bulk Carriers No.	Bulk Carriers Age	Tankers No.	Tankers Age
U. S. - privately owned	965	19	606	19	57	22	275	17
Denmark	342	10	246	10	19	8	57	6
Germany, Fed. Rep.	860	11	725	11	69	9	51	10
Japan	1406	9	881	10	234	6	265	7
Netherlands	469	11	311	11	34	7	88	10
Norway	1356	10	616	12	256	6	455	8
Sweden	433	11	265	13	85	9	74	7
United Kingdom	1985	12	1154	12	297	10	423	10

Source: Maritime Administration, A Statistical Analysis of the World's Merchant Fleets, December 1966, p. 1.

The differences in average age reflect disparities in average size, speed and other efficiency factors. The United States fleet will not begin to move toward greater competitiveness with the merchant marine of these countries until it too initiates a substantial program for the replacement of overage tonnage.

The Youthfulness of Foreign Fleets Reflects the Effectiveness of Regulations that Encourage Fast Depreciation and Reinvestment of the Proceeds of Ship Sales

The countries with much more youthful merchant marines than the U. S. all encourage much faster depreciation of new ships. [1/] Earnings before depreciation on a new ship tend to be high because its new features attract cargoes. Moreover, maintenance and repair costs are at a minimum, as is time lost for repair and maintenance. Higher depreciation allowances in these early years permit a higher cash flow to the operators at the expense of taxable earnings. If the operator can sell his ship after accelerated depreciation allowances have been used up, and either defer tax payments on his net profit over book value or pay such taxes at reduced rates, he has a substantial incentive to buy a new ship. These incentives exist in every country listed in Table No. I, except the United States.

Thus since April 1965, the owner of a U. K. ship may claim depreciation at any rate he chooses for each year. In effect, he can take the entire depreciation for one ship in one year if feasible and his profits permit. The U. K. does not tax capital gains.

1/ See Maritime Administration, Maritime Subsidies, 1969. Details on depreciation allowances and tax treatment of ship operators are provided for most maritime countries.

Sweden permits depreciation of 30 percent of book value per year or a complete write-off in five years. Thirty percent of the contracted price may be depreciated prior to delivery of the vessel. Taxable earnings from the sale of vessels may be transferred to a special fund which, if used to acquire new vessels, is not taxable.

Germany permits depreciation of a dry cargo ship over 14 years and a tanker over 12 years, using either a straight line or a declining percentage that may not exceed twice the applicable straight line percentage. However, between 1965 and 1970, a special depreciation of up to 30 percent may be taken during the first five consecutive years. Book profits from the sale of a ship may be transferred without tax to a replacement ship.

Norway permits accelerated depreciation up to 25 percent of cost, beginning as soon as the first installment has been paid under a new building contract. If used on a ship for which ordinary depreciation is seven percent, the vessel will be written-off within 11 years. Capital gains may be put in a special fund and used to finance new investments.

By contrast to such treatment, U. S. operators are expected to depreciate an unsubsidized vessel over an 18 year period. Subsidized vessels are depreciated over 20 or 25 years. The declining balance and sum-of-the-years digits methods of accelerated depreciation may be adopted. Income tax at regular rates, rather than at capital gain rates, must be paid on the proceeds of the sale of a ship. The subsidized operator only gains tax advantages from the possibility of depositing earnings in a capital reserve fund for the purchase of new ships. On the other hand, such a fund establishes no special incentive for early investment in new ships. Unlike the operators of foreign flag ships, the U. S. operator has substantial undepreciated value for tax purposes on his ten-year old ship and less incentive to contemplate replacement.

U. S. Flag Ships Now Carry Only a Token Percentage of U. S. Foreign Trade

In 1967, U. S. flag ships carried fewer than 29 million tons of U. S. imports and exports, less than half as much as in 1950. This absolute decline reflects a much more dramatic drop in the percentage of total U. S. waterborne trade carried in U. S. bottoms. Though U. S. waterborne imports and exports tripled in tonnage over this period, the decline in the share of the U. S. flag fleet has been continuous and persistent since 1950. That share equalled 39 percent in 1950, 23.5 percent in 1955, 12.3 in 1960, 8.1 in 1965, and only 6.5 in 1967.

TABLE NO. II

U. S. WATERBORNE IMPORTS AND EXPORTS, 1950 TO 1967

	Tonnage (millions of short tons)			U. S. Flag Ships (in percent)		
Year	Total	Dry Cargo	Tanker Cargo	Total	Dry Cargo	Tanker Cargo
1950	159	100	59	39.3	31.2	53.0
1955	254	169	85	23.5	23.2	23.5
1960	323	202	120	12.3	15.2	7.5
1965	427	274	153	8.1	9.3	5.9
1967	444	294	150	6.5	8.1	3.4

Source: Bureau of Census, Statistical Abstract of the United States 1969

The Level of Output of the U. S. Merchant Shipbuilding Industry Has Been Much Too Low to Permit Production at Minimum Cost

Over the past five years, 1963-1968, an average of only 15 merchant ships a year were completed in all U. S. shipyards. The level of output has been dependent primarily on the availability of government construction subsidies.

A variety of expert opinion has emphasized the economies inherent in producing a standardized ship in series. For example, the Booz Allen study previously mentioned estimated the cost of its 40,000 ton dry bulk ship at $16 million for the first ship, but $12.1 per ship if an order of 15 ships were placed with a single U. S. yard. Because U. S. labor skills and wage rates are both high, the economies of serial production are undoubtedly much greater than in foreign yards. Given a substantially higher volume of orders and some reasonable assurance that the higher level would be maintained for a period of years, the U. S. shipbuilding industry is likely to become more specialized and adapted to serial production.

The industry has no significant recent experience with the economies of serial production, so that estimates of possible cost reduction per ship may well be conservative. The full economies can only be known after several U. S. yards experience orders for a standardized vessel in series of fifteen each, repeated for the same or another standardized ship well before production of the first series is completed. With such a pattern of orders on their books, U. S. yards would be able to equip themselves appropriately, order more efficiently from suppliers and organize their production so as to take full advantage of modern shipbuilding technology and the skills of U. S. labor and management.

Since the investment tax credit was enacted in 1962, U. S. shipyards have engaged in a substantial investment program designed to

expand and modernize their capacity. According to the Census Bureau, [1] new capital expenditures by the industry have risen steadily -- from $23 million in 1962 to $24.5 million in 1963, $32.8 million in 1964, $44.2 million in 1965, $52.8 million in 1966 and $66 million in 1967. Reports to the Shipbuilders Council indicate that the figure for 1968 approximated $100 million. If substantial replacement of obsolete ships in the U. S. fleet is to be achieved, this investment program in U. S. shipyards must be continued.

This ambitious and costly program was stimulated by the availability of investment tax credits to ship operators and by an expectation that the government of the United States would soon take substantial measures to overcome the block obsolescence of the U. S. merchant fleet.

In the last two years, orders for new U. S. built ships have increased, primarily for new tanker tonnage. Without tax incentives or other government support, even this modest step toward renovation of the U. S. merchant marine may be set back.

The Maintenance of Inefficient Ships in the U. S. Fleet Involves Substantial Costs to the Federal Budget

Ship operating subsidies for liners engaged in serving Essential Trade Routes at international cargo rates have been running at about $200 million per year. Otherwise, overage vessels have been able to continue in service only in protected markets -- domestic shipping and government-sponsored cargoes in foreign trade. Rates have been substantially higher than would be required on efficient new ships. The use of such ships increased the costs and expenditures of the Departments of Defense and Agriculture as well as the Agency for International Development. A modern dry bulk cargo fleet might save 75 percent of the

1/ Published in reports of the Annual Survey of Manufacturers.

transportation costs now borne by the Department of Agriculture's Food for Peace program. These costs have amounted to as much as $80 million a year.

THE NATIONAL INTEREST IN THE MERCHANT MARINE

It is unprecedented for a major power to become as dependent on foreign flag fleets for the transport of its international commerce as has the United States. It is possible to take comfort from the fact that adequate shipping has been available even during periods of international crisis. However, with the prospective disappearance of the reserve fleet, U. S. flexibility and credibility during future crisis situations may be seriously restricted.

The Soviet Union has come to place a much higher priority on the development of its own merchant marine. It has grown from 1.8 million deadweight tons in 1950 to 3.6 million in 1958 and about 12 million tons at present. In November of 1968, it was reported to have 458 ships on order, aggregating more than four million deadweight tons. At the same time, only 62 ships were on order for the U.S. fleet, totalling 1.8 million deadweight tons.

However one views the security implications of U. S. dependence on foreign flag shipping, the foreign exchange costs are high. The U. S. balance of payments deficit has averaged about $2 billion per year throughout the 1960's and gives little evidence of improvement. The U. S. surplus on merchandise trade virtually disappeared in 1968. The Department of Commerce [1/] is pessimistic about the prospect for reestablishing the large trade surpluses which existed even in the mid-1960's.

In such circumstances a significant national interest must prevail in saving foreign exchange or finding new avenues for earning foreign exchange without causing serious disruption in the free flow of international commerce. A recent study concluded that the U. S.

1/ U. S. Department of Commerce, U. S. Foreign Trade: A Five Year Outlook, 1969

balance of payments "would have suffered a loss of approximately $2.2 billion for the three year period 1964-1966 if the shipping services performed by the U. S. flag fleet ..... had been performed instead by foreign owned and operated vessels." 1/ Since the U. S. fleet carried less than ten percent of U. S. foreign trade in that period, a modest improvement in its share of U. S. foreign commerce would have made a significant contribution toward ameliorating the U. S. balance of payments deficit.

Perhaps even more serious is the cost of ships purchased from foreign yards by U. S. nationals. Since 1946, 1650 new ships were purchased for registry under foreign flags. The U. S. balance of payments accounts keep no separate record of expenditures for such purchases, but they must have totalled $5 billion and may well have reached $8 billion. There is no sign of any diminution in these purchases.

Recently a single U. S. operator ordered eight ships from European yards at a reported cost in excess of $250 million. These vessels are to be financed abroad, so that purchase and interest costs together are likely to aggregate at least $350 million, a foreign exchange cost to the U. S. which could have been avoided if the ships were obtainable from U. S. yards at comparable cost to the operator.

The President has reasserted a goal of carrying 30 percent of U. S. foreign trade on U. S. flag ships. Though the past year has been one of substantial debate and dissent about a wide variety of national goals and priorities, this one has been remarkably free of criticism. In any reasonable assessment of national needs, the maintenance of a

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1/ Harbridge House, The Balance of Payments and the U. S. Merchant Marine, 1968, p. 7

substantial merchant marine must claim serious attention. The merchant marine today requires prompt and effective measures to cope with its advanced obsolescence.

USING INVESTMENT INCENTIVES TO MODERNIZE THE U. S. MERCHANT MARINE

In a free enterprise system, investment incentives through the tax system can be a potent force for achieving national purposes. If the objective be to expand and modernize the privately operated U. S. fleet with ships built in private U. S. shipyards, it is likely to be realized sooner and more efficiently through such incentives.

The investment tax credit was a most potent instrument for raising business investment and accelerating plant expansion and modernization in the U. S. economy as a whole. Indeed the proposal to eliminate it stems from the belief that such investment proceeded so rapidly that its pace can now be moderated. Resources need to be directed more toward other national priorities such as urban problems and poverty. If the maritime industry also deserves priority attention, it should seek investment incentives through the tax system to encourage rapid modernization of the merchant marine.

Investment Incentives are an Efficient Way to Promote Expansion and Modernization of the Merchant Marine

The problems of the U. S. merchant marine are attributable, in some degree, to the direct subsidy techniques through which it has received government support. The administrators of public funds are accountable for their expenditure. They must therefore supervise the use of public funds in great detail and review decisions with great caution. A competitive private enterprise, however, requires flexibility and decisiveness. Success usually comes to those who are prepared to innovate and take risks on the basis of experienced judgment. The administration of maritime subsidies brings these legitimate concerns of officials and business men into constant conflict. The efficiency of the U. S. maritime industry has undoubtedly been victimized by

such conflicts. Moreover, the system depends on annual decisions by the Executive Branch and the Congress concerning how much money is to be available. Uncertainty, instability, indecisiveness and over-cautious supervision are thus loaded on the industry by the subsidy system.

Investment incentives through tax legislation have important advantages over the present methods used by the government to support the merchant marine. Shipbuilders and operators can count on their availability, unless another legislative process modifies them. The incentives for shipbuilders to reduce construction costs and for operators to maximize revenues and to minimize operating costs will be greater. The benefits of efficiency will accrue to the builders and operators and will show up in their earnings reports. The government will share in these benefits through income tax collections.

A Variety of Techniques Should be Employed to Provide Effective Investment Incentives to the Maritime Industry

Permitting operators to depreciate new ships rapidly for tax purposes is probably the most efficient technique, particularly if the proceeds from the sale of a heavily depreciated vessel can be fully reinvested in new ships free of tax payments.

A two year period normally elapses between the signing of a contract for a new ship and the delivery of the completed vessel. Down payments must be made and a construction loan obtained and serviced long before the operator realizes income from operating the vessel. At current interest levels, such costs are a significant burden, particularly for small operators. If the operator were permitted to charge depreciation on the vessel under construction against the earnings of ships already in operation, he can realize part of the down payment he must make on the new ship.

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While U. S. tax law permits the use of any reasonable depreciation method consistently applied, Internal Revenue Service guidelines certainly inhibit departures from the 18 years suggested therein. Even if the accelerated depreciation techniques generally available to U. S. taxpayers are adopted by the ship operators, the result is an unrealistically low rate of write-off of ship costs. Relatively high earnings during the first years after a new ship is delivered produce large tax liabilities and a modest cash flow to the operator. In later years, the relatively large undepreciated balance encourages continued operation of older vessels, despite lower earning power and higher operating costs.

A powerful incentive for modernization would be established -- and the financing problems of small operators would be eased considerably -- if owners were permitted to write-off the full cost of a new ship within ten years, using accelerated depreciation methods as earnings permit. To facilitate financing downpayments, they should be permitted to write-off at least 15 percent of the cost of a new ship between the contract and delivery dates.

To initiate rapidly a substantial modernization program for the U. S. merchant marine, a special depreciation allowance might be offered on new ships for which contracts are placed before 1975. Owners would be permitted to depreciate 30 percent of the contractual cost within the first five years after delivery of the vessel, in addition to regular depreciation charges for those years. Such an allowance would offer owners a significant inducement to contract for replacement tonnage within the next five years. Owners taking advantage of such a provision would be able to increase their depreciation charges in any of the first five operating years of a new vessel in which earnings prove to be high, thus augmenting their cash flow at the expense of their tax liability.

While U. S. flag ships should not be expected to have an economic life in excess of ten years, the ships would continue to be attractive to the fleets of lower wage countries. A substantial international market should continue to exist for such vessels and U. S. owners should expect to sell new ships within a ten-year period for sums considerably in excess of scrap value. If the proceeds of such sales were exempt from taxation provided that they are reinvested in new ships within a few years, operators would be encouraged both to take advantage of the new depreciation allowances and to replace ships as annual depreciation charges diminish.

Such incentives should attract specialized financial institutions to invest in new ships under leasing or long-term charter arrangements, as well as ship operators. New sources of private capital for the maritime industries might then be developed.

Lenders would also be attracted by a special tax deduction on gross interest income from construction and mortgage loans on new ships, as well as on lease or charter income from new ships. Such a deduction should reduce the high interest rates currently required on ship mortgages, as well as draw private capital to financing the fleet modernization program. A similar reduction has been recommended by the Treasury as an incentive for investment in residential real property loans, student loans and "certain other loans which are made pursuant to national policy objectives." 1/

Investment incentives such as the foregoing have played a major role in the modernization of foreign flag fleets. They should also be effective under U. S. conditions. If the incentives are restricted to new ships ordered from U. S. yards, the annual cost to the Treasury in the form of taxes foregone would be nominal for the next few years. As the

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1/ Statement by the Assistant Secretary of the Treasury for Tax Policy before the Senate Finance Committee, September 4, 1969.

numbers of ships involved increase, losses of tax receipts would be offset in substantial measure by reductions in budget expenditures for government sponsored cargoes. Moreover, despite such depreciation allowances, a profitable merchant marine and shipbuilding industry will be a better source of tax revenues than the present obsolete fleet and shipyards building a few ships a year. As for the balance of payments of the United States, it would benefit by a multiple of any reduction in tax collections.

October 1, 1969

STATEMENT FOR THE RECORD

ON BEHALF OF

GEOTHERMAL RESOURCES INTERNATIONAL, INC.

COMMITTEE ON FINANCE
UNITED STATES SENATE

INTRODUCTION:

This statement is submitted on behalf of Geothermal Resources International, Inc. (hereinafter "GRI") to request the Senate Finance Committee to clarify existing law with respect to the definition of "gas" as that term is used in the Internal Revenue Code of 1954. The Tax Court of the United States has recently held in Arthur E. Reich, et al., v. Commissioner (52 TC No. 74, July 31, 1969) that geothermal steam is a gas. Accordingly, the Court held that participants in successful steam drilling ventures are entitled to deduct percentage depletion. Moreover, that the petitioners were entitled to elect to expense the intangible costs of drilling and developing geothermal steam wells. It is our understanding that the Internal Revenue Service, undaunted by this setback, intends to continue to disallow both depletion and intangibles for all taxpayers engaged in this

industry and to force such taxpayers to litigate these issues. To obviate this wasteful expenditure of both time and money, we respectfully request your Committee to direct in the legislative history of H.R. 13270 that the term "gas" as used in the Internal Revenue Code includes geothermal steam. A summary of the reasons for this action is set out below.

BRIEF HISTORY OF GRI:

A brief discussion of GRI's activities is included in this statement since we believe GRI is typical of the small young company which is pioneering the use of geothermal steam as a source of electrical energy in the United States. GRI is the survivor of a 1965 merger involving four small corporations, each of which had prior to the merger either been engaged in the drilling for geothermal steam or owned interests in land believed potentially capable of producing geothermal steam. GRI is presently engaged primarily in the business of drilling for and producing geothermal steam for sale as a source of energy for generating electric power to be used by industry as well as other consumers of electric power.

Since 1963, GRI has restricted its drilling efforts to areas in Sonoma and Modoc Counties, California, but, with advances in technology and the availability of land

for additional drilling, GRI hopes to expand these operations. In the summer of 1967, GRI drilled the GRI-Rorabaugh #1 steam well as a discovery well in an area now designated by the company as the Rowan Steam Field in the Geysers area of Sonoma County, California. The well was completed at a depth of 3,676 feet after encountering the tope of the productive interval at a depth of 3,400 feet. The company subsequently drilled six additional wells, designated GRI-Rorabaugh #2 - 7 (all located in close proximity to the well #1), two of which are presently capable of producing geothermal steam, and four of which may well produce steam upon the completion of remedial drilling. GRI has financed the drilling of these wells in part through private equity offerings under permits issued by the California Commissioner of Corporations. Without the availability of the right to expense intangible costs of drilling and developing geothermal steam wells and the right to deduct percentage depletion on income received from successful wells, GRI will be unable to secure the additional capital needed for further exploration.

DISCOVERY OF GEOTHERMAL STEAM:

Actually, in a few foreign lands, geothermal steam is old hat. For example, Icelanders use natural steam to heat their homes, and Italians built the first power station using natural steam at Larderello in 1904. The Italian field now boasts a 400,000 kilowatt rating which is nearly matched by similar fields in New Zealand. Most of this activity occurred many years ago but recently in other foreign countries, there has been a surge of interest in the geothermal process. Countries now exploring and developing geothermal steam include Mexico, Japan, Russia, Nicaragua, El Salvador and Guatemala. Research on the subject is being sponsored in some less developed countries by the United Nations.

In the United States geothermal steam has, until recently, been considered uneconomic. However, with technological improvement and more complete geological surveys, the use of geothermal steam to generate electric power holds great potential. Recently, Union Oil Company of California, Magma Power Company and Thermal Power Company formed a joint venture to drill for and sell geothermal steam from Nothern California wells to Pacific Gas & Electric Company. Although no one knows the ultimate potential of

geothermal steam, some forecasters give it only a small percentage of the market - perhaps 2 or 3 per cent, but in such a huge market even 2 or 3 per cent is a tremendous amount of electric energy. It is estimated by Dr. James McNitt, formerly a geologist for the California Division of Mines and Geology and now a geologist for the United Nations, that there are more than 1,000 known geothermal regions in Western United States. Of these, he says, only 11 have been drilled extensively enough to assess their potential.

Drilling and geological evaluation indicates that the techniques used to locate oil and natural gas are applicable in the search for natural steam. The entry of prominent oil companies into the natural steam industry has resulted in an accelerated application of petroleum exploration methods. In addition to field mapping, such procedures as sub-surface studies through electric log correlation, gravity surveys, magnetometer surveys and heat sensing surveys are now commonly employed in the quest for steam accumulations. Steam wells, like oil wells, may be drilled with rotary or cable tool drilling equipment, and although the drilling technique is quite similar to that used in oil, the blow-out preventive equipment on steam wells must handle much higher temperatures than comparable equipment on oil wells.

The first step in drilling a steam well is to select the well site and stake the point where a drill will pierce the surface. The site is graded and leveled to accommodate the drilling rig as well as the other equipment necessary for operation. The well site includes mud sump or pit varying in size in relation to the depth the well will be drilled and a well cellar to accommodate the blow-out prevention equipment. The equipment used in the actual drilling of the well includes the mast or derrick, pipe rack and 40-foot lengths of pipe, drill collars and bits, mud tank for drilling fluid, diesel engines to power the mudpump, portable generators and floodlight equipment, christmas tree or well head equipment to contain high pressures and the various hand tools and rig safety devices used in any drilling operation.

The derrick is rigged up over the drillpoint and drilling commences to a shallow depth, whereupon surface or guide casing is cemented into place. Drilling is then continued through water-bearing horizons, perhaps, to a depth of 2,000 feet, whereupon a second string of casings, known as the water string, is run to depth and cemented into place to prevent contamination by surface waters. Drilling

continues to the projected depth usually between six and nine thousand feet. GRI's wells have depths ranging from 6,500 feet to 7,280 feet with the total footage drilled to date approximately 50,920 feet, including five redrills. A reservoir of steam was encountered in the GRI-Rorabaugh #1 well at about 3,400 feet below the surface of the ground, and the cost of this discovery well was approximately $250,000. The cost of the second well was nearly $750,000 while the remaining wells have been drilled at an average cost of approximately $475,000. The high cost to drill the second well was due to mechanical and other difficulties encountered during drilling and should not be considered as truly representative of the cost to drill an ordinary steam well. Although a supply of steam has been discovered at relatively shallow depths at a cost of $50,000 to $75,000, in GRI's experience such finds represent rare exceptions rather than the rule.

Once a well is determined to be capable of producing steam, both in quantity and pressure sufficient to warrant the expense of completion, a pipeline gathering system, consisting of large diameter fully insulated pipe is attached to the wellhead. This system runs to a point where pressure regulating equipment necessary to control the

steam pressure and/or volume is located. The pressure regulating equipment is connected to a steam turbine by expansion joints and pipelines. The controlled steam pressures and/or volume is used to turn the turbine which, when directly connected to a generator, produces electricity. At the point where the steam has spun the turbine, its energy is, for all practical purposes, dissipated. It is uneconomic to transmit steam for long distances, and accordingly, electric power plants which use geothermal steam as a power source, must be located at, or very near, the steam wells. Transmission lines from these power plants are then connected to the grid system.

Recently, GRI retained International Engineering Company, Inc. to prepare an analysis of the cost to construct a 300 megawatt plant, exclusive of transmission, inter-connections and switching costs. This analysis presupposed the construction of two 50 megawatt and two 100 megawatt plants, and the total estimated cost was $32,000,000. Although the tremendous costs connected with the development of geothermal steam as a power source for the production of electric energy exceed similar costs for oil and natural gas, the benefits to be derived from the use of geothermal steam are well worth the expense.

BENEFITS OF GEOTHERMAL STEAM:

The use of geothermal steam as a power source for electric energy has several significant advantages, not only to the consumer, but to the general public. Based on our experience (and the experience of the Union Oil - Magma - Thermal group), we project that geothermal steam, when produced in adequate volume, will compete very favorably with other sources of electric power. Indeed, once the generating plants are constructed, we project that electric energy produced from geothermal steam can be sold at from 25 to 40 per cent less than the current cost of producing such energy under conventional methods per kilowatt hour. These figures are real - not mere projections. For example, the Union Oil - Magma - Thermal joint venture is selling steam to Pacific Gas & Electric Company at a profit and Pacific Gas & Electric, through its well-site turbines, generates electric power at a cost 20 per cent below that for conventional fuels.*/ Presently, Pacific Gas &

*/ This cost figure was contained in a Wall Street Journal article dated June 10, 19[illegible].

Electric has a total rated capacity in its geothermal power system at the Union Oil - Magma - Thermal wells of 82,000 kilowatts, and Pacific Gas & Electric has recently announced two additional units to be completed in 1971 and 1972, raising its capacity to 192,000 kilowatts.

In addition to lower prices, geothermal steam has two other significant benefits - the complete lack of air and water (thermal) pollution. Nuclear power, viewed by many as the key to generating electricity in the future, has one serious drawback - it contributes substantially to thermal pollution. As this Committee is well aware, air and water pollution are high on the list of the serious problems facing this nation. The production of electric energy from geothermal steam not only is free from air pollution but also creates no water pollution which would endanger fish or other aquatic life. Moreover, no demand is made on existing water supplies.

The availability of a low cost power source of electric energy which is completely free from air and water pollution can not be overlooked. Initially, the beneficiary of such power will be California, the state with perhaps the best known smog problem. Various sources estimate that the power demands in California will double in

the next seven years and will continue to double every ten years thereafter. It would, however, be clear error to suggest that only California will benefit from geothermal steam as a power source. Some estimate that geothermal steam could be used on a nationwide basis. We are unable to confirm or deny such estimates, but we are convinced that it can be of significant benefit to all Western and Southwestern states within a relatively short period of time.

CONGRESSIONAL ACTION IS NECESSARY:

As noted above, the Tax Court of the United States held in Arthur E. Reich et al., v. Commissioner (52 TC No. 74) that geothermal steam was a gas as that term is used in the Internal Revenue Code of 1954. Nevertheless, the Internal Revenue Service intends to continue to litigate this issue forcing taxpayers to expend both time and money in defense of court-approved deductions. Further, and perhaps of even greater significance, taxpayers in the geothermal steam industry will be unable to raise additional capital to finance new exploration and development of steam wells so long as IRS continues its present policy. In an effort to change that policy, we request this Committee to clarify the legislative history of the term "gas" by stating in its Committee report on H.R. 13270 that the term gas includes geothermal steam for all relevant provisions of the Code.

There should be little doubt that geothermal steam is a natural resource which should be developed as a pollutant-free source of electric energy. The discovery of, and drilling for, geothermal steam utilizes the techniques of the petroleum and natural gas industries. The entry of prominent oil companies into the natural steam industry has resulted in an accelerated application of these exploration methods. The expert testimony presented in the Reich case supra establishes that geothermal steam is contained in a closed reservoir, in a finite amount, with no significant liquid influx. The only recourse we have to stop further IRS attack is for this Committee to direct in a legislative history of H.R. 13270 that geothermal steam is a gas for all relevant provisions of the Internal Revenue Code.

Geothermal Resources International, Inc. stands ready and willing to supply any additional information which the Committee might desire and to assist the Committee or its staff in any way.

Thank you for the opportunity of presenting our views.

Respectfully submitted,

Noeth B. Gillette
President, Geothermal Resources International, Inc.

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