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TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED FRIDAY, SEPTEMBER 26, 1969

PART B—ADDITIONAL STATEMENTS

(Topics: Real Estate, Depreciation Deductions and Recapture; Public Utilities Depreciation, Earnings and Profits, Etc.)

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

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Real Estate Depreciation Deductions and Recapture

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SUMMARY
of
TESTIMONY OF WALLACE R. WOODBURY,
Chairman, Subcommittee on Taxation, Realtors' Washington Committee and a Vice-President of the National Association of Real Estate Boards, before the Senate Finance Committee
September 26, 1969

Introduction: Several provisions of H.R. 13270 will have an intensely adverse effect on everyone connected with real estate, whether as property owner, investor, builder, broker, tenant, or just as resident or worker in an urban community.

NAREB Position on Tax Reform: Endorses the concept of minimum tax provided that all sources of so-called tax preferences be included in order not to impair real estate's already precarious competitive role in the private investment market. The limit on tax preferences (LTP) in the bill does not meet this criterion. House-approved and Treasury-recommended exceptions would make real estate the principal if not sole target of LTP.

Douglas Commission on Urban Problems recommended that an income tax system should include special preferences to housing investment ... warned that any "loophole-closing" ...if applied only or more strenuously to this (real estate) than to other competitive investment fields, would probably curtail the flow of resources and managerial efforts into this area."

Critical Condition of Real Estate Industry: For 15 years construction has been accounting for a slowly declining proportion of gross national product. This has made the "problems of the cities" the nation's primary domestic concern. It is essential that the development of commercial structures, industrial and warehousing facilities, as well as housing, keep pace with population growth and the trend toward urbanization, and opportunity for replacement and renewal.

H.R. 13270 will have a depressing effect on real estate construction, improvement and maintenance. It will occur at a time when shortages are developing in residential and non-residential properties, and our national housing goal of 26 million units in 10 years is receding from view.

SUMMARY OF ARGUMENTS AND RECOMMENDATIONS

Depreciation: The 150% depreciation method now available for existing buildings should be restored. Limiting existing buildings to the straight-line method has already had a serious restricting effect on the resale market.

Present accelerated methods (200% double declining balance and sum-of-the-years digits) should be available to non-residential new construction. Elimination of such methods will result in reduced yields to investors. In a competitive financial market investors will seek out other high yield and less risky sources than real estate investment.

Should the Congress enact a provision to recapture a greater portion of depreciation taken in excess of straight-line as ordinary income, there is no logical basis for discouraging real estate investment and construction through denial of existing accelerated methods.

Recapture: The proposal in the bill to recapture as ordinary income all depreciation taken in excess of straight-line, without limitation as to time, is an extremely harsh measure which does not differentiate between a long-term investor and a short-term holder of real estate. The Committee might consider a provision that for the first five years all depreciation in excess of straight-line be recaptured as ordinary income, then reduce the percentage of gain taxed as ordinary income 1% per month. Certainly an investor who has held property for more than thirteen years is entitled to full capital gains.

The House-approved bill purports to retain an incentive for new residential construction and for rehabilitation of low and moderate income housing by allowing more rapid depreciation. Such incentive is almost completely neutralized by the harsh recapture provision in the bill.

Limit on Tax Preference: The LTP should be abandoned altogether unless all sources of so-called preferential income are included. The House has eliminated the oil industry; the Treasury wants to eliminate tax-exempt interest on local and state bonds and appreciated value of assets donated to charity. This leaves real estate and the so-called gentleman farmer as the only targets for LTP — an unnecessary and inequitable discrimination that should be repudiated by the Committee.

Limitation on Deduction of Investment Interest: The Treasury Department has properly recommended that this provision be eliminated from the bill. The provision is discriminatory, unworkable, and would discourage holding unimproved land for future development.

Installment Sales: As presently drafted the proposal on installment sales reporting would discourage the development of unimproved property because builders must await development and adequate outside financing before they can pay fully for the land and incur tax liability. The House bill greatly over-reaches the problem at which it is aimed and its retroactivity is unconscionable. The provision should be deleted until a provision can be formulated which would not interfere with legitimate and necessary methods of financing real estate transactions.

Hobby Losses: Loose general language in this provision would deter the holding of property in deteriorating neighborhoods because lack of current profit would create a presumption that the venture is not profit-motivated and all deductions would be disallowed. Abandoned buildings are proving a tremendously vexing problem to urban areas; this provision in the bill would aggravate this problem because it would have the effect of further increasing the cost of holding property in blighted areas.

Allocation of Deductions: The Committee should recognize that interest, taxes, and casualty losses for rental real estate are business deductions and should not be subject to allocation; also, interest and taxes on unimproved real estate held for development should be considered business deductions and not subject to this allocation provision.

Statement of Wallace R. Woodbury, a Vice-President of the National Association of Real Estate Boards and Chairman, Subcommittee on Taxation of the Realtors' Washington Committee, before the Senate Finance Committee, regarding H.R. 13270 as it affects real estate

September 26, 1969

INTRODUCTION

Mr. Chairman and members of the Committee--

I welcome this opportunity to testify on behalf of the National Association of Real Estate Boards in these hearings on H.R. 13270, the Tax Reform Act of 1969.

First, by way of background, I am a Realtor engaged in the business of real estate brokerage, management, development, appraising, and mortgage banking in Salt Lake City. I am a Vice-President of the National Association of Real Estate Boards and Chairman of the Subcommittee on Federal Taxation of its Realtors' Washington Committee. Our Association consists of more than 89,000 Realtors who are members of more than 1,500 boards of Realtors located in every state in the Union. Our members are engaged primarily in the business of brokerage, management, and appraising. However, the activities of our membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and industrial development.

Our Association is familiar with the problem of the large number of individuals and corporations who take the risk of developing and operating real property. The problems of the real estate industry affect not only the risk takers who participate in development and operation of real estate, but also the hundreds of thousands of people who depend upon the construction industry for their livelihood, and the millions of individuals and corporations who rent or own real property.[1/]

Several provisions of this bill will have an intensely adverse effect on everyone connected with the real estate industry, whether as property owner, investor, builder, broker, tenant, or just as resident or worker in an urban community. This

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1/ $7.3 billion of multifamily residential housing was put in place in 1968; commercial construction in 1968 amounted to $8.3 billion. Real estate construction provides employment for more than 3.2 million people.

is our first opportunity to comment on these provisions. The House Ways and Means Committee requested testimony on the possible modification in the treatment of real estate where accelerated methods of depreciation are used, and we testified on that.[2/] The bill before this Committee is not limited to this provision, but it attacks the real estate industry in a variety of ways with a number of novel and complex provisions:

1) Severe limitations on the availability of accelerated depreciation;

2) A harsh and unfair rule for recapture of accelerated depreciation on disposition of the property;

3) Application of the Limit on Tax Preferences (LTP) with particular emphasis on real estate deductions;

4) Application of the allocation of deductions with particular emphasis on real estate deductions;

5) Limitations on deductibility of investment interest; and

6) A "hobby loss" rule designed for gentleman farmers which literally would apply to all real estate which fails to produce taxable income.

We believe it is desirable for this Committee to evaluate the operation of these proposed adverse changes in the light of their actual impact on private property ownership and the real estate industry today.

However, before discussing the status of the industry, I believe it is desirable for the Committee to be aware of the position our Association took last winter on the question of tax reform. We also wish to call attention to the report of the Douglas Commission on Urban Problems with respect to our industry and the tax laws.

POSITION AS TO TAX REFORM TAKEN BY NAREB IN MARCH 1969

Probably the single most significant fact with respect to the consideration of tax reform was the disclosure by Acting Secretary of the Treasury Joseph Barr in January 1969 that for the year 1967 there were 21 individuals with adjusted gross incomes in excess of $1,000,000, and 154 individuals with adjusted gross

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2/ The sole real estate issue proposed for testimony by the Ways and Means Committee read: "As to possible modification in the tax treatment of real estate where accelerated methods of depreciation are used."

incomes in excess of $200,000 who paid no federal income tax.

It should be noted that the principal causes of this result for these taxpayers were the deduction for charitable contributions (49 cases), personal interest (72 cases), and state and local income taxes (12 cases) (Treasury Tax Reform Proposals, April 22, 1969, page 67, table 5). These cases could not have resulted from accelerated depreciation of real estate and capital gains, since these items are taken into account before arriving at adjusted gross income.

Some of the provisions of the tax reform bill are directed toward preventing these results. Many other provisions appear to be not so directed.

In March 1969, prior to the hearings before the House Ways and Means Committee on tax reform, the Realtors' Washington Committee of the National Association of Real Estate Boards met to consider an official position to recommend to the Board of Directors of our Association on the subject of tax reform. Notwithstanding the fact that representatives of various industry groups were taking the position that no changes in the tax laws were necessary, the Realtors' Washington Committee responsibly recognized that there were some tax inequities and recommended a positive approach to prevent these inequities. Specifically, the following resolution was recommended for adoption by the National Association's Board of Directors:[3/]

> "The National Association of Real Estate Boards urges that no changes be made in the tax laws which will impair the competitive position of real estate in the investment market.
>
> "To assure that all persons assume a share of the burden of taxation, we recommend that the Internal Revenue Code be amended to provide for a minimum income tax, which would be applicable if it exceeds tax liability under the regular rates. Such a minimum tax should be based on an expanded income base, which must include the following without exception: (1) the excluded one-half of long-term capital gains, (2) tax-exempt state and local bond interest, (3) percentage depletion in excess of cost depletion of property, (4) excess of fair market value over basis of property contributed to charity, (5) intangible drilling expenses, and (6) excess of accelerated depreciation over straight-line depreciation (with appropriate adjustments to basis). Such expanded income base should be subject to a graduated rate not in excess of one-fourth of the regular ordinary rates.

3/ Approved March 26, 1969 by NAREB Executive Committee. Subsequently approved by the Board of Directors May 13, 1969, with an amendment to add the following to the end of the second paragraph: "We recommend a 5-year carryover of any disallowed deduction as an offset to future income from the six items recited above."

"We vigorously oppose the imposition of a capital gains tax on the appreciated value of capital assets at the time of death of an owner; but we support a change in the tax law so that heirs and legatees succeed to the cost basis of the decedent with an appropriate adjustment for inheritance or death taxes paid."

NAREB continues to adhere to this position. We favor the approach now known as Limit on Tax Preferences (LTP), which has the same purpose as the minimum income tax, which would get at these inequities provided that the approach is applied across the board to all areas considered productive of potential tax inequity and not directed primarily toward real estate. We would similarly favor alternative approaches directed at accomplishing the same goal, particularly if simpler than the intricate, complex provisions of the House bill.

We have serious objections to the bill as passed by the House and to Treasury proposals made to this Committee, not because we object to changes to prevent tax inequity but because under the proposals essentially only real estate (and so-called gentleman farmers) would feel the hot breath of LTP. As passed by the House, five items would be included in LTP:

1) tax exempt interest;
2) certain farm losses;
3) the excess of the value of property contributed to charity over adjusted basis;
4) the excess of accelerated depreciation of real property over straight-line depreciation;
5) the 50% long-term capital gains deduction.

Specifically omitted were percentage depletion and intangible drilling expenses.

Further, Treasury now proposes to omit from LTP tax-exempt interest and the excess value of appreciated property contributed to charity. Treasury proposes to add percentage depletion and intangible drilling expenses plus two real estate items: (a) the excess of losses during the construction period over income and (b) the excess of rapid amortization of rehabilitation expense on low and moderate income property over straight-line depreciation which deduction was created by Section 521 of the bill itself.

If the Treasury proposals are adopted and the House view prevails on the oil industry, the only areas reached by LTP provisions would be real estate (three separate provisions plus the long-term capital gains rule) and the so-called gentleman farmer.

REPORT OF THE NATIONAL COMMISSION ON URBAN PROBLEMS
(DOUGLAS COMMISSION) AS TO REAL ESTATE AND THE TAX LAWS

Moreover, the provisions of H.R. 13270 are also inconsistent with the Report of the National Commission on Urban Problems. In Chapter 7 at page 10 the Commission stated:

> "...our special concern here is with the effect of present arrangements upon incentives for investment in housing, and it seems clear (1) That existing tax provisions have been 'institutionalized' into a complex set of economic relationships that involve a large volume of investment as well as the provision of rental housing for about one-third of all American families; and (2) That any 'loophole-closing' efforts, if applied only or more strenuously to this than to other competitive investment fields, would probably curtail the flow of resources and managerial efforts into this area. ..." (emphasis supplied)

The provisions of LTP which apply "loophole-closing" more strenuously to real estate than to other competitive investment fields will do exactly what the Douglas Commission said it would do, that is, curtail the flow of resources and managerial efforts into this area — at the same time that this area needs greater efforts rather than less.

The Douglas Commission (page 11 of the same chapter) recognizes that "the Nation has an obvious stake in adequate investment in commercial as well as residential plant." It goes on to state that because of the particular public and social concern with housing, the question arises whether the income tax system should include some special preference to housing investment, and this question is considered in the final section of the chapter where the Commission makes its three recommendations.

The first of these recommendations is that the Treasury Department make an intensive analysis and submit explicit findings and recommendations concerning tax law changes best suited to provide materially more favorable investment in new residential construction (including major rehabilitation) than for other forms of real estate investment. This recommendation does not mean that the income tax laws should be changed in the manner proposed by H.R. 13270, so as to impose severe burdens on all real estate investments with slightly lesser burdens on housing.

Such provisions seriously impair the competitive position of real estate as an investment. Rather, the Commission appears to contemplate only those changes in the tax law which would give new preferences to investments in residential construction.

Such new preferences are more specifically identified in the other recommendations of the Douglas Commission - that preferential depreciation allowances or investment credits be provided for investment in governmentally-subsidized low and moderate income housing and that there be especially generous tax treatment of investor-owners' expenditures for maintenance and rehabilitation of older rental residential structures (for example, the rapid amortization of rehabilitation provided by Section 521 of the House bill).

CRITICAL CONDITION OF THE REAL ESTATE INDUSTRY

We believe that at this point it is desirable for the Committee to consider the present state of the real estate industry.

Necessity for Commercial and Industrial as Well as Residential Real Estate

First, as we discuss in more detail below, the proposed bill attacks all aspects of the real estate industry but places special additional burden on commercial and industrial real estate as compared to residential real estate. This is inconsistent with the needs of the country.

We are not a nation of dormitories. Although housing is in critically short supply, the development of livable communities entails more than the erection of suitable living quarters. Unless a concept of the "total community" remains viable, through equal treatment and encouragement of residential, commercial, and industrial development, we shall find ourselves unable to provide effective housing relief. Those who need housing the most will be unable or unwilling to remove themselves to a sterile community which is inaccessible to employment, shopping, and services.

Today, about 75% of our population live in an urban environment. If current projections materialize, 85% of the population will be living in and around cities by the year 2000. It is essential that the development of commercial structures, industrial and warehousing facilities, as well as housing, keep pace with population growth and the trend in urbanization, and provide opportunity for replacement and renewal.

By common consent the problems that we lump together as the "problems of the cities" are the nation's primary domestic concern. Solutions to these problems are being sought under programs that we know as urban renewal, model cities, and other actions to rebuild vitality into the hearts of our cities. None of these programs can succeed if the end product must be confined to providing new residential dormitory space around the fringes of these areas. An era of true urban renewal and rebirth of our great city centers must rest on a balanced program of providing facilities for every type of urban land use, including needed commercial and industrial development and upgrading of existing facilities to make the result a viable community.

Impact on New Construction

Secondly, these provisions of H.R. 13270 will adversely affect construction of buildings, an essential element for the replacement and renewal of the nation's physical plant in general, and the urban community in particular. Construction by the private sector of the economy has not been keeping pace with the current boom, and it will suffer even more under the proposed provisions.

Over the past 15 years construction has been accounting for a slowly declining proportion of gross national product. Construction's share in current dollars dropped from almost 12% in 1955 to 10% in 1967 and held at that level last year. More significantly, while public construction more than kept pace with the rise in gross national product, private construction failed to enjoy a similar increase in rate.

Despite accelerated depreciation as an investment attraction, the rate of growth fell behind other sectors of the economy, whether viewed as a share of gross national product or as a share of gross private domestic investment.

Shortage of Supply

Third, the depressing effect of these new provisions of H.R. 13270 on real estate construction, improvement, and maintenance is occurring at a time when there is developing a real shortage of supply in both residential and nonresidential properties.

Occupancy rates in habitable residential properties are higher than at any time since the period immediately following World War II. Rates are impressively high also in commercial and industrial structures.

Results of the Census Bureau's sample survey of residential vacancies show a decline in the rental vacancy rate from 7.2% in the first quarter of 1960 to 5% in the same quarter of this year. Our routine NAREB market report indicates a similar level of scarcity at all price levels.

Similar occupancy trends have been experienced in the nonresidential component of the market. Our Spring 1969 report indicated that the demand for commercial and industrial space more than kept pace with additions to the inventory over the past four or five years. The market readily absorbed the volume of office space added by both new construction and renovation, with the result that, last spring, vacancy rates in prime location center city buildings were 2% or less in nearly one-half (47%) of the nation and 3%-5% in 31%. In office buildings located in the suburbs a vacancy rate of 2% or less was reported for 45% of the nation and 3%-5% for 42%. At the same time, the demand for industrial space is accelerating and vacancies in both manufacturing and warehousing structures and single-story design were lower than the previous year in more than three-fourths of the country. The Building Owners and Managers Association's survey of office space occupancy showed continuation of the upward trend this year. An increase of 2.7% in occupancy over May 1968 was reported.

Those who desire to occupy residential and nonresidential property will be the sufferers as a result of the effect of the new tax provisions in reducing the supply of new real estate or usable improvements to real estate.

Furthermore, the Ways and Means Committee made at least one significant factual error in its decision. The House Report (page 166) states: "The present /depreciation/ treatment creates a tax environment favorable to frequent turnover which tends to discourage long-range 'stewardship' and adequate maintenance." In our judgment, there is no factual basis for this statement. The truth is exactly the reverse. It is precisely the owner who is going to sell who must maintain his property in order to make it as attractive as possible to prospective purchasers; if he does not, he will either be unable to sell or he will have to take a substantial discount because of poor maintenance. It is precisely the owner who is going to hold for a long time (either by choice or because he is "locked in") who can skimp on maintenance, doing only enough to keep tenants minimally satisfied.

Finally, it should be noted in the revenue considerations applicable to these provisions that the one certainty of the government obtaining revenue is the case where the taxpayer will sell his property at a gain. <u>Discouraging such sales is bound to decrease the federal revenue</u>. No revenue is obtained because of increases in value in the absence of a sale. It is true that decreasing the depreciation deduction may improve revenue collections, but this is true only to the extent the taxpayer is in fact operating his property at a profit, so that the depreciation deduction offsets what would otherwise be taxable income. The taxpayer must reduce his tax basis by allowable depreciation regardless of whether or not it produces a tax benefit. Accordingly, this depreciation deduction (whether or not it produces a tax benefit) does tend to result in a potential gain on the sale of the property if the property does not decline in value as rapidly as the applicable depreciation. The tax on this gain (and in the usual case on the greater gain which results from appreciation in value of land) is not obtained by the government except in the event of sale.

Thus, we have two situations which are <u>not</u> taken into account in this bill. One is the fact that discouraging sales may result in property not being properly maintained. Secondly, it will tend to decrease revenue because of the postponement of collection of the tax now collected when sales are made at a gain.

Importance of Real Estate Industry to the Economy

The enormous potential impact of a cutback in real estate construction on the economy can be seen from the following figures:4/

	Private Construction (In Billions)	Private Nonfarm Housing Starts (In Thousands)	Contract Construction Employment (In Millions)
1963	$ 43.9	1,581.7	3.0
1964	45.8	1,502.3	3.1
1965	50.3	1,450.6	3.2
1966	51.1	1,141.5	3.3
1967	50.6	1,268.4	3.2
1968	57.0	1,483.6	3.3

THE ECONOMIC IMPACT OF H.R. 13270

The newspapers are full of stories that the main effect of the tight money policies of the Federal Reserve System, inaugurated in the beginning of this year, has been felt by real estate. Mortgage money is less and less available and at higher and higher cost. The financial squeeze has caused a real estate recession which has already caused untold hardship to tenants, to home owners, to construction workers and suppliers. The ripple effect from them to the rest of the economy is substantial. Tight money was the first punch against real estate in 1969.

If the tax reform bill is enacted as approved by the House, and even more so if the additional Treasury proposals recommended at the eleventh hour are enacted, these proposals will be the second punch. Taken together this one-two punch will cause a serious real estate depression with grave consequences for the entire economy.

4/ Source: Census Bureau, Department of Commerce; Bureau of Labor Statistics, Department of Labor; Department of Research, NAREB.

ANALYSIS OF ADVERSE PROVISIONS OF H.R. 13270

We shall now address ourselves to some of the major provisions of the pending bill which will cause the adverse effect on real estate which we have described above.

Depreciation of Real Estate

Congress thoroughly considered the application of accelerated depreciation to real estate in connection with the Revenue Act of 1964. As a result of its consideration, the Congress decided to leave unchanged the provisions for accelerated depreciation of real estate. It did enact a recapture provision now incorporated in Section 1250 of the Internal Revenue Code. Under this provision, gain on the sale of a building, to the extent of depreciation taken, is taxable as ordinary income in full if the property is sold in the first year, and to the extent of all or a portion of the excess of the depreciation taken over straight-line depreciation if the building is sold after the first year and before the end of the tenth year. This excess is treated as ordinary income under a sliding scale dependent on the period the property is held, starting at 100% for the first eight months after the first year, and decreasing 1% a month from the 20th month until the end of the tenth year.

This is the existing law. It provides an adequate solution of the problems considered by the Committee. The 1964 law recognized that the problems arise only when there is a too rapid turnover of the property. Depreciation does in fact take place; buildings are in fact used up and are subject to obsolescence. After property has been held a substantial period of time, such as the period recognized in Section 1250, its sale at a gain does not represent any error in the computation of depreciation, but instead represents an appreciation in value of the remaining property which is the result of the same economic factors that cause appreciation in value of other investments (often appreciation in value of non-depreciable land).5/

5/ It was for this reason that the Ways and Means Committee in 1962 decided not to act on a Treasury recommendation for full recapture of real estate depreciation. "...Committee decided not to apply this treatment to buildings or structural components of buildings at this time because testimony before the Committee indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period..." H.Rept 1447, 87th Cong., 2nd Sess. (1962), p. 67.

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Usually these factors are either inflation, a good income-producing record, or scarcity. This appreciation in value arises not from the property used up with the passage of time, but the remaining property. This appreciation in value is as much a capital gain as the appreciation in value of vacant land held for a number of years, or the appreciation in value of stock listed on the New York Stock Exchange. It might be noted that many listed stocks represent interests in corporations which take substantial deductions each year for depreciation, depletion, or both, and there is no recapture provision applicable to such stock.

An additional reason why accelerated depreciation is proper is because the Treasury requires real estate to use antiquated, unrealistically long useful lives which have not been revised for 27 years.[6/] The combination of accelerated depreciation and overly long useful lives produces a barely adequate, not an excessive, deduction.

6/ The Treasury in 1962 provided guidelines as to the useful life of property. For property other than buildings, these were far more liberal than the previous administrative rules (which were last revised in 1942) and represented a realistic acceptance of the increasing impact of technological obsolescence. This obsolescence is also true of buildings. The Treasury guidelines in 1962 recognized obsolescence for farm buildings by reducing the prescribed useful life of farm buildings from 50 years to 25 years. However, in the case of all other buildings it either retained or increased the previously prescribed useful life, requiring the use of periods that run from 40 to 60 years, and also eliminated the advantages of the building component method for shorter life portions of the building. The past Administration's Treasury Department officials have admitted that this was not an adverse factual determination by the Department but merely its reaction to Congress not adopting its 1961 recommendation as to real estate. "Since no action was taken by the Congress to provide recapture of excess depreciation on real estate, the administrative revision of depreciation guidelines in 1962 was confined, in effect, to personal property. While guideline lives were provided for buildings, they were essentially the same as those in Bulletin F with the exception of farm buildings." — Tax Reform Studies and Proposals, U.S. Treasury Department (February 5, 1969). p. 447.

We might further note that the law enacted in 1964 has been in effect for only a little more than five years. There has been no new information produced before this Congress to indicate that any change in the law is necessary. On the other hand, we feel that the changes now incorporated in this bill would be disastrous for the real estate industry, as well as for millions of people affected by it.

First, this bill would change the existing laws relating to the depreciation deductions allowable for real estate. Presently, all new real estate construction (residential, commercial, and industrial) is eligible for the double declining balance or sum-of-the-years digits method of depreciation. All used buildings are presently eligible for the 150% declining balance depreciation method.

The bill would continue double declining balance and sum-of-the-years digits methods of depreciation only for new residential rental housing. Other new construction would be limited to 150% declining balance depreciation. All used property (residential, commercial, and industrial) would be limited to straight-line depreciation.

Furthermore, the bill would change the recapture provisions of existing law so as to eliminate the provision under which recapture decreases over a 10-year period. Instead, it would treat as ordinary income all of the gain on the sale of a building – whether residential, commercial, or industrial, and whether new or used – to the extent of the excess of accelerated depreciation taken after July 24, 1969 over straight-line depreciation.

The bill does have one provision that provides a new incentive for rehabilitation if made to older residential property with low and moderate income tenants where unit expenditures for rehabilitation are between $3,000 and $15,000. Such rehabilitation costs would be written off on the straight-line method over a five-year life. However, the Treasury has requested this Committee to neutralize almost all of the benefits of this provision by providing that such deductions for renovation be treated as excess depreciation to be recaptured as ordinary income when the property is sold.

We cannot be too emphatic in our assessment of the adverse effect of the provisions limiting depreciation and increasing recapture. The depreciation deduction is directly related to the effective yield of an equity investment in real estate. In turn, the effective yield is an important factor in determining the value of the real estate investment. Hence, the reduction of the depreciation allowance results in a reduced yield; and the reduction in yield results in a reduced value. New construction is at a cost level which does not justify its being undertaken for the type of yield that would be available if this bill were enacted. The immediate effect of this bill will be that investors, who will seek the same yield they are presently receiving for the type of risk they are taking, will no longer invest in new construction. They will seek other sources of investment which are available to them, many of which have been considered in connection with this bill and left undisturbed.

We have already noted above the serious adverse effect on the nation from a drying up of new construction and a slowing down of the real estate industry. We are convinced that the House-passed bill contains the seeds of erosion of the privately financed real estate industry. We believe that this Committee must come to grips with the needs of the country for continuation of a healthy urban environment by rejecting the House approach.

Furthermore, the one area of buildings not subject to cutback in accelerated depreciation — that is, residential construction — is in fact penalized almost as much as other types of construction because of the recapture rules. Double declining balance depreciation will not be the needed adequate incentive for residential construction if the benefits given with one hand are taken away with the other hand by the harsh recapture rule of the House bill. Indeed, the President's Committee on Urban Housing (the Kaiser Committee) concluded that recapture under existing law had an adverse effect on investment in low and moderate income housing and recommended deletion of the present recapture rule for low and moderate income housing. ("A Decent Home" - Report of the President's Committee on Urban Housing, pp. 83-85) Similarly, the advantage purportedly given through a five-year useful life for rehabilitation costs would be largely removed if the same recapture provisions are applicable to these expenses.

The total recapture of the excess of accelerated depreciation over straight-line depreciation will virtually freeze or "lock in" any new investments which are made in real estate, and quickly stagnate the flow of capital into the industry, at the same time cutting down the flow of revenues to the Treasury. Obtaining equity financing is becoming very difficult if not prohibitive. The equity invested in real estate is a non-liquid asset. It is not traded on an established exchange or in an established market. It may or may not be readily saleable. This significantly increases the risk as compared to other investment opportunities, and demands a commensurately higher projected yield on the investment. The recapture provisions of the bill will significantly reduce the yield in the event of sale and greatly increase the cash payment requirements, while the allowance of only straight-line depreciation to a potential buyer will drastically reduce the already inadequate market for used buildings. The combined effect of these provisions will be, initially, a sharp acceleration of the present drop in real estate construction and development (because the return is inadequate). This must ultimately be followed by sharply increased rents to restore a competitive return to the investor before a belated increase in construction. This is highly inappropriate at a time when construction of housing units is less than 60% of the national goal. Many hundreds of thousands of persons will live in inadequate housing during the adjustment period.

It is our firm belief that existing methods of depreciation of real estate must be continued in order to maintain and increase the flow of equity capital into the real estate industry, consistent with the national housing goals and the maintenance of a viable real estate industry.

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However, our Association recognizes that some changes may be made in the Section 1250 recapture period without producing an excessively drastic effect on real estate. The present Section 1250 provides for total recapture of the excess of accelerated depreciation over straight-line depreciation during the period from the 12th through the 20th month, declining 1% per month thereafter, so that at the end of ten years there is no recapture. If the Committee deems it necessary, the period of total recapture of such excess could be extended for four years, from the 12th through the 60th month, thereafter declining 1% per month. We believe that any capital gains thereafter resulting would surely be a consequence of capital appreciation and not unrealistic depreciation deductions. The market adjustment which such a change would necessitate, though adverse to real estate, might, we think, be within acceptable limits.

This change could be made very simply by changing the number "20" in Section 1250(a)(2) to "60". This change would eliminate eight pages of complex provisions in Section 521 of the bill, leaving only those provisions which grant a five-year write-off for certain rehabilitation costs.

Limit on Tax Preferences

The limit on tax preferences (LTP) provision has been publicized as the "minimum income tax" which sets a 50% limitation on the use of certain "tax preferences." The President has hailed the original proposal as a "major step toward assuring that all Americans bear their fair share of the federal tax burden." (Message from the President, April 21, 1969) However, the present posture of LTP is that it means "Let Them Pay" - and "them", we regret, are primarily investors in real estate.

We have supported, and we continue to support, a minimum tax proposal which would apply equally to all forms of income, and would maintain the equilibrium among investment opportunities.

As originally recommended by the Administration, the preferences included in LTP were:

(a) Percentage depletion on minerals and intangible drilling and exploration expenses in excess of normal deductions under regular accounting rules;

(b) The excess of accelerated depreciation over straight-line depreciation on buildings;

(c) Farm losses arising from unrealistic accounting methods;

(d) The excess of market value over basis of property contributed to charity.

The LTP proposal which is contained in HR 13270 added tax-exempt interest on state and local bonds to the items of tax preference recommended by the Treasury, and deleted percentage depletion and intangible drilling and exploration expenses.[7/] The Treasury Department, in its statement of September 4, 1969, has again insisted that tax-exempt interest be excluded as a preference item, and the Department has changed its mind regarding the preference status of gifts of appreciated property to charity by urging its deletion from the list of tax preferences. Furthermore, the Treasury has recommended the addition of two more real estate items to the list of tax preferences: interest, taxes, and rents paid on real property during the period of construction of improvements thereon, and the rapid amortization of rehabilitation expenditures for low cost housing.[8/]

Thus it appears highly possible that all that will be left of the widely touted minimum tax proposal is a higher tax on real estate investors (and some so-called gentleman farmers), while buyers of tax-exempt bonds, owners of oil properties, and donors of appreciated property to charity will continue to have substantial opportunity to escape income tax. The result of this situation would

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7/ The bill also includes as a tax preference the excluded one-half of long-term capital gains, but it has been acknowledged that this is virtually meaningless because it would rarely affect the tax liability of a taxpayer.

8/ In addition, the Treasury has recommended that tax preferences should include accelerated depreciation in excess of straight-line depreciation on certain leased personal property, and percentage depletion and intangible drilling costs in certain cases.

inevitably be an outflow of equity investments in real estate toward these other opportunities for investment where current yields and market prices will remain stable. This is not tax reform but tax discrimination against real estate.

This is an intolerable situation for the real estate industry. The current market for various investment opportunities has been developed over the years so that investment yields are balanced in the context of relative risk, liquidity, management problems, and other factors which enter into one's judgment in choosing among available investment opportunities. In addition to upsetting the established investment yields from real estate through the drastic cutback in depreciation allowances and provisions for recapture contained in the bill, the present status of the LTP proposal singles out real estate as the almost exclusive object of LTP.

Further, the mechanics of LTP are such that it is quite impractical to attempt to compute its effect on a projected investment yield. LTP only affects tax liability when the items of "tax preference" exceed other income. Therefore, a taxpayer must (1) project his other income for each year of his projected investment in real estate — usually an impossible feat, (2) project the amount of his "tax preferences" for each such year — also usually impossible, and (3) compute the effect on his tax liability for each such year. Aside from the effect on the market price of real estate, it seems obvious that it would be simpler to choose a form of investment which is not subject to LTP rather than make these complicated and estimated computations in order to determine the merits and desirable terms of a real estate investment.

We, therefore, believe it is inappropriate, and misleading to the public, to impose a "minimum tax -- on investment in real estate," and we believe that enactment of the LTP in such form would result in an unprecedented upheaval in the real estate industry. If there is to be a minimum tax, it should be a true minimum tax, which treats all investments alike. It would also be desirable if such an approach were mechanically much simpler than the complex LTP proposal.

Limitation on Deduction of Interest

Section 221 of the bill would impose an annual limitation on the amount of the allowable deduction for interest expenses paid by non-corporate taxpayers on funds borrowed to purchase or carry property held for investment. The maximum interest deduction each year would be $25,000 plus a taxpayer's net investment income and his net long-term capital gains.

The apparent purpose of the limitation on the interest deduction is to provide a "matching" of interest expense deductions with the income from the investment in respect of which funds were borrowed giving rise to the interest expense. It is assumed that a taxpayer would thereby be precluded from offsetting other income with interest expenses for an investment which is not yet producing income. The approach adopted in the bill is in lieu of an actual tracing of an interest expense to a particular investment, which would obviously be administratively unworkable.

However, the House-passed provisions do not work, and the Treasury Department has recommended their deletion.

This provision discriminates between a taxpayer who has current income-producing investment and a taxpayer who incurs an interest expense but has no current investment income. In the former case, the taxpayer may deduct his interest expense to the extent of his investment income even though the income-producing investment is unrelated to the interest expense, while the deduction may be denied to the taxpayer who is making his initial investment even though he has other non-investment income. Even worse, the carryover provisions of the bill do not allow the interest expense to be offset against the income from the investment at such time as the taxpayer receives it.[9/]

If a taxpayer buys unimproved real estate and an interest deduction (for the mortgage loan incurred to carry it) is disallowed under the bill, he will not be able subsequently to deduct the interest from future income from any improvements he puts on the property (unless it is under a net lease), because the rents are considered business income against which the "investment interest" may not be a deduction. Whether or not the deduction will be later available will turn on whether or not the taxpayer net leases the property in the future. This startling result is obviously unfair. Also, the taxpayer has the unanswered question of whether there is proportioning if the taxpayer builds a shopping center and some stores are under a net lease and others are not, such that all of the income is reportable but only a portion of the actually paid expenses would be deductible.

Installment Sales

Section 412 of H.R. 13270 would amend the provisions of the Code relating to the installment method of reporting income from the sale of real property by providing a definition of an installment transaction which precludes from installment treatment those transactions in which the payments are not spread out in a prescribed manner over the installment period.

9/ Some of the anomalies of the provision are: (1) The bill provides that the disallowed interest deduction may be carried over from one year to the next only to the extent a taxpayer has taxable income (which cannot be offset by the interest deduction) for the year of disallowance. If a $100,000 interest deduction is disallowed in 1970 when a taxpayer has $80,000 of taxable income, only $80,000 may be carried over to 1971; and if the taxpayer has only $20,000 of earned taxable income in 1971, only $20,000 of the original $100,000 originally disallowed interest would seem to be available as a carryover to 1972. (2) Also, it appears that even though an interest deduction has been disallowed in one year, the carryover may be disallowed in a subsequent year under the allocation of deductions rules of the bill. (3) Furthermore, the bill discriminates against taxpayers who have investments in two or more partnerships as opposed to a single partnership because the disallowance provisions apply at the partnership level first and then a second time at the partner's level. Therefore, the interest deduction of a taxpayer from one partnership may be prevented from offsetting his investment income from another partnership.

Although the primary purpose of this provision is to preclude deferral of income in a corporate "reorganization" transaction where the acquiring corporation gets a stepped-up basis for the acquired property, the definition is drafted so that it inappropriately affects the legitimate purchase money financing of many real estate transactions. For example, it is common in real estate transactions for sales to be made with relatively small payments to the seller for a substantial period, such as during the development of unimproved property, thereby allowing the buyer to use his resources for the development until adequate outside financing can be arranged. The provisions of the House bill would preclude this type of financing arrangement by imposing an immediate income tax liability upon the seller in such cases even though he has not received the proceeds of the sale to which the tax liability is attributable.

We submit that it is not an abuse of the installment method to allow this type of financing, and that the remedy contained in the House bill greatly over-reaches the problem at which it is aimed. We urge the Committee to examine this matter and to formulate a provision which will not interfere with the legitimate and necessary methods of financing real estate transactions.

Hobby Losses

Section 213 of H.R. 13270 would provide a new "hobby loss" provision which would deny a taxpayer the deduction for losses from a business activity where the activity was not operated with a reasonable expectation of realizing a profit from it. In addition, where an activity has been carried on at a loss in excess of $25,000 for three out of five consecutive years, it would be deemed — unless shown to the contrary by the taxpayer — that the activity is carried on without a reasonable expectation of realizing a profit.

Although included in the provisions dealing with farm losses, the provisions would literally apply to real estate.

The purpose of this provision is to preclude the utilization of losses by taxpayers to offset their other income where the losses are not incurred in a bona fide business activity.

It is submitted, however, that the test provided for determining the validity of a "business" activity fails to take into consideration an increasingly common business situation where there is no realistic expectation of realizing a profit but with respect to which a deduction should nevertheless be allowed: the case of a business property which has so declined in value that there is no reasonable expectation of selling it at a profit, and the taxpayer is holding it for sale at a loss or is waiting for some improvement in the market which will reduce his loss.[10/]

One effect of the "hobby loss" provision would be to accentuate urban blight by destroying the market for many properties in difficult geographic areas. There are 12,000 to 15,000 abandoned buildings in New York City alone, presumably because the cost of demolition exceeds residual value. Many more abandonments would follow enactment of the hobby loss provision since it would have the effect of further increasing the cost of holding property in blighted areas.

Furthermore, the presumption that there is no reasonable expectation of realizing a profit from an activity when there are losses in three out of five consecutive years poses an unfair burden upon the legitimate real estate developer of unimproved property, where rezoning, development, and "rent-up" costs may produce losses for an extended period. Although this presumption may be rebutted, it is an inviting sword to be used by the government in highly inappropriate cases — "You have losses and are therefore deemed not to have a reasonable expectation of realizing a profit." The Commissioner of Internal Revenue already

10/ The Treasury proposal of September 4, 1969, that "profit" be defined to include any reasonably anticipated long-term increase in the value of property does not seem adequate to cover those cases where there is no existing market for the property and where the property may even be expected to decline in value during the period when a buyer is being sought. It would tend to create "panic" sales.

has a general presumption of correctness in his favor when he asserts a tax liability. The addition of a new statutory presumption in this fashion would be an invitation for Revenue agents to conclude that hard, factual analysis of each situation is unnecessary; the presumption gives the answer.

It is therefore submitted that if there is to be a test relating to expectation of profit, this added presumption is unnecessary and likely to cause undue controversy because it implies the rejection of factual analysis.

Allocation of Deductions

This provision is directed at personal deductions. We believe it desirable that the Committee recognize that interest, taxes, and casualty losses for rental real estate are business deductions not subject to this section, and that interest and taxes on unimproved real estate held for development as rental property are also business deductions not subject to this section.

NATIONAL ASSOCIATION OF HOME BUILDERS

1625 L STREET, N.W., WASHINGTON, D.C. 20036

SUMMARY OF STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS Before The COMMITTEE ON FINANCE UNITED STATES SENATE ON H.R. 13270

September 26, 1969

SUMMARY OF PRINCIPAL POINTS

A. Provisions of H.R. 13270

1. Retention of accelerated depreciation for new rental housing (Section 521(a));

2. Elimination of increased recapture of depreciation on real property (Section 521(b));

3. Elimination of restriction to straight-line depreciation by second owner of rental housing (Section 521(a));

4. Elimination of the treatment of excess of accelerated depreciation over straight-line on rental housing as a "tax preference" for purposes of the Limit on Tax Preferences of individuals (Section 301);

5. Elimination of the treatment of excess of accelerated depreciation over straight-line on rental housing as a factor in computing the allocation of deductions (Section 302);

6. Elimination of rehabilitation expenses (under Section 521(a)) from the computation of depreciation recapture on the disposition of low-cost rental housing (under Section 521(c));

7. Modification of the limitation on installment method to exempt sales of real estate purchased and used for the construction of single-family or multifamily housing (Section 412); and

8. Elimination of limitation on deductions of certain non-exempt membership organizations (Section 121).

B. Recommendations for Additional Provisions

1. Allowance of an investment account for dealers in real estate;

2. Exclusion from gross income of the first $750 of interest income on deposits in thrift institutions;

3. Preferred tax treatment for interest income from single family residential mortgages; and

4. Condition continued tax exemption of income earned by pension funds on investment of a percentage of assets in residential mortgages.

NATIONAL ASSOCIATION OF HOME BUILDERS

National Housing Center

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STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
Before The
COMMITTEE ON FINANCE
UNITED STATES SENATE
on
H.R. 13270
September 26, 1969

Mr. Chairman and Members of the Committee:

My name is Louis R. Barba. I am First Vice President and Chairman of the Legislative Committee of the National Association of Home Builders. I have with me our Tax Counsel, Mr. Leonard L. Silverstein, and our General Counsel, Mr. Herbert S. Colton.

The National Association of Home Builders consists of approximately 51,000 members in 473 affiliated state and local associations. Our members build over 75% of the residential construction in this country, including both single family housing and apartments. They thus perform a vital economic and social function -- a function which the Congress has recognized and encouraged for the past 35 years.

Attached as an appendix is a more extensive statement of our views on several portions of H.R. 13270. Since our time is limited, I can sum up these views in a sentence or two: -- H.R. 13270 would completely cancel that 35-year effort insofar as rental housing is concerned. It would drastically curtail the flow of investment capital at the very time when our industry already faces critical credit problems.

1. Recapture of Depreciation

While the bill would retain 200% accelerated depreciation on new rental housing, it would almost completely negate this (1) by the provisions which greatly increase recapture; (2) by restrictions on depreciation which may be taken by a second owner; and (3) by inclusion of accelerated depreciation in the limited tax preferences and the related allocation of deductions.

The bill would practically destroy the resale market for depreciable real estate. Owners of "locked in" rental housing could not afford to sell their property at any point prior to the end of its useful life, which could be 40 years or more. This is because under the bill any sale prior thereto would result in recapture as ordinary income of the entire amount of excess accelerated depreciation over straight-line. Facing such a "lock in" developers would not dare build; investors would not find rental housing attractive; and those few who did invest would not be able to revolve their funds for reinvestment in new construction.

We oppose Section 521(b) which removes the present concept of a cumulative percentage reduction in depreciation recapture.

2. Restrictions on Depreciation

We also object to and recommend elimination of the provisions in the bill which would limit "second owner" depreciation on rental housing to straight-line.

We recommend the existing 150 percent depreciation for second owners of residential rental housing be retained.

This would be consistent with the proposed retention of 200% depreciation on newly constructed rental housing.

Limitation to straight-line depreciation on property in the hands of a second user penalizes rather than encourages ownership of rental housing in that the differential between the rate applicable to the first owner and that applicable to the second owner is greater for rental housing than for other types of buildings.

The total impact of the proposed increased depreciation recapture plus the restriction to straight-line depreciation on used rental housing, and the interaction of these two proposals, will assuredly have a disastrous effect on the housing industry. Owners of rental housing will not sell (because of the substantial depreciation recapture) and potential purchasers will not be interested in buying (because of the limitations to straight-line depreciation). Investment funds will be diverted from new rental housing -- always and inherently a highly dubious investment on a pure economic basis -- into other more attractive forms of investment.

3. Limited Tax Preference and Allocation of Deductions

The home building industry supports the concept of a minimum income tax. We believe everyone in the United States should pay a fair share of taxes.

However, we think the captioned proposals would further significantly diminish the stimulation of accelerated depreciation for residential rental housing, in that it includes the excess of accelerated depreciation over straight-line.

The potential damage is compounded by the failure of the bill to relate the LTP proposal to the bill's other proposals to increase depreciation recapture, as discussed above. As now proposed, an investor partner in rental housing would be required to recognize ordinary income twice on the same dollar of accelerated depreciation: first under LTP in the year when excess depreciation is claimed on a property and a second time upon the later disposition of the property.

This is the "coup de grace" to an industry which would be already well-nigh mortally wounded by the recapture and second owner depreciation provisions. We recommend that this double penalty for investment in rental housing be eliminated.

Under Section 302 of the bill, individuals would be required to allocate otherwise allowable personal deductions in such a fashion as to result in disallowance of the excess of accelerated depreciation over straight-line. This would further deter equity investment in rental property.

We recommend elimination of the excess of accelerated depreciation over straight-line as a factor in computing the allocation of deductions.

We also urge the Committee to reject the recommendation made by the Treasury to expand LTP to include as a "tax preference" the amount of excess interest, taxes, and rent over receipts (if any) from unimproved real property during the period of construction. This militates directly against new construction. Such expenses are integral elements of the total costs of construction and take place prior to receipt of rental income. They should not be penalized. The proposal completely ignores the economic realities of construction.

4. Rehabilitation Expenses

NAHB supports the proposals in the pending bill (Section 521(a)) to provide special depreciation benefits for rehabilitation of low-cost rental housing.

However, the incentive for such rehabilitation -- the proposed 5-year write-off of expenditures -- is also substantially destroyed by the inclusion of such expenditures in the computation of depreciation recapture under Section 1250.

We recommend that rehabilitation expenditures which qualify under this proposal be excluded from the application of depreciation recapture under Section 1250.

We also urge the Committee to reject the proposal of the Treasury that such expenditures be included as a "tax preference" within the LTP concept. Inclusion of such expenditures would deter owners of low-cost rental housing from incurring rehabilitation expenses and completely frustrate the purpose of the proposal.

5. Installment Sales

We object to the proposed limitation under Section 412 of the bill in the use of the installment method of reporting gain to the extent that this limitation would operate on the sale of unimproved land to be used for residential construction. The proposed limitations on the installment method should be amended expressly to exempt a sale which involves unimproved real property where the

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taxpayer establishes that the property is bought and will be used for the construction of single family or multifamily housing.

Builders are hard-pressed to arrange for the acquisition of land on economically feasible terms. They need the greatest possible flexibility in the payment terms for such acquisitions. Buying land for subsequent housing developments ordinarily involves payments to the owners over a long period of years. The proposed percentage limitations under Section 412 of the bill will arbitrarily limit builders unnecessarily in their negotiations. We doubt that it was the purpose of the House that these installment method amendments apply to land purchases.

6. Non-Exempt Organizations

NAHB strongly objects to the enactment of Section 121 of the bill which would limit the deductions incurred by a membership organization in furnishing services to its members to the amount of income derived from members or from transactions with members. Such provision would, if enacted, severely curtail the performance by NAHB, as a membership organization of, its sole function of furthering the interests of the home building industry. It would similarily affect many of our affiliated state and local associations.

The problem presented by Section 121 of the bill arises with respect to the income derived by NAHB from the conduct of its Annual Convention, which constitutes one of the largest trade shows conducted in the United States. It is undertaken for the sole purpose of educating its members; it presents to its members the new products and techniques in the home building industry to enable them to construct better and more efficient housing.

Income from the Convention is derived from the rental of exhibit space to manufacturers and other organizations directly related to the home building industry which, through exhibits, display such new products and techniques. While a member of NAHB seeing a product which is of interest to him may request to be contacted by the respective exhibitor at a later date, there are no sales transacted at the Convention and it cannot, therefore, be considered as a "sales facility".

Except in the "sales facility" situation, the underlying concept of a "trade show" is that it represents an event designed to permit the interchange of knowledge for the benefit of all of its members. The exhibits represent practical workshops at which the dissemination of information as to new developments and techniques is undertaken in order to educate the members of the industry and increase their technical competence.

The "trade show" often makes it possible for members of the industry to become aware of new products and materials which have not otherwise been introduced in their geographical area. In addition, the ability to see the new products and materials in use provides a method whereby the member of the industry can determine the practical application thereof in improving the products or services of such member and his colleagues in the industry.

The non-sales facility "trade show" thus is undertaken for and in fact serves to promote the common business interest of its members through education and information on new products, materials and techniques. Moreover, in most industries the rapid technological advance which this country has been experiencing makes it imperative that the associations provide such "trade shows" in order that their members be kept abreast of the new developments and techniques in order to effectively operate and thereby improve business conditions in their industry. Indeed, the association conducting such "trade show" would thereby be directly promoting the common business interests of its members and more nearly achieving the purpose for which it was formed.

The proposed limitation on deductions should thus be inapplicable where, as in the case of the NAHB Convention, the income is derived from an activity which "contributes importantly" to the performance by the membership organization of its express function.

7. Incentives for Housing

This bill before you presents Congress with a unique opportunity to provide the people of the United States with improved opportunities for attaining the Nation's housing goals. The great problem facing the industry currently is a severe lack of mortgage funds. There is every reason to believe this will continue in the foreseeable future.

We propose that this Committee add to the pending legislation an amendment which would allow a taxpayer to exclude from income the first $750 of interest income on deposits in thrift institutions.

Thrift institutions, primarily savings banks and savings and loan associations, are the primary source of funds for the home building industry. They are finding it increasingly difficult to attract consumer savings because of the competition from other sources offering higher rates than thrift institutions can afford to pay.

The Internal Revenue Code currently provides a deduction for stock dividends as encouragement for investment in stocks. We believe savers require similar treatment.

Further we urge the Congress to increase the attractiveness as investment instruments of mortgages on single family housing by giving preferred tax treatment to interest income from single family home mortgages.

The single family mortgage instrument in today's economic and inflationary climate has completely lost its attractiveness to investors. The national monetary policies for controlling inflation have fallen with catastrohpic impact upon the source of mortgage funds for single family home mortgages. The nation can ill afford to have the single family housing industry largely destroyed or curtailed during this current period. Such preferred tax treatment would not only be consistent with the stated national policy of encouraging home ownership, but it will also enable the single family home industry to better ride out periods of severe monetary restraint such as we are now in.

We propose that Congress condition the continued tax exemption of the income earned by pension, retirement, and similar funds on investment of a percentage of assets in residential mortgages.

Pension funds are the fastest growing pool of savings in the country. The Congress should determine whether their high percentage of investment in equity risk securities is sound and in the long-term public interest. We believe that residential mortgages, now almost completely neglected by pension funds, could and should become a much safer investment resource for pension funds and that conditioning their continued tax exemption on such investment is necessary to achieve the needed shift in their investment emphasis.

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APPENDIX

DETAILED STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
COMMITTEE ON FINANCE
UNITED STATES SENATE
on H.R. 13270
September 26, 1969

The National Association of Home Builders is the trade associate of the home building industry. Our membership totals approximately 51,000 members who are grouped in 473 affiliated state and local associations and who build over 75 percent of the residential construction in this country. As such, our members have a basic interest in providing adequate housing (both single and multifamily) for all Americans in all income levels at prices and rents they can afford.

Our members therefore have a vital interest in several of the provisions of H.R. 13270, the Tax Reform Act of 1969, which we feel would substantially impair the flow of investment funds into, and the construction of, multifamily rental housing units which this country has committed itself to by the enactment of the Housing and Urban Development Act of 1968. We are concerned that the enactment of these provisions would drastically diminish new multifamily construction and require substantially higher rents on the small amount that would be produced, thereby, of course, rental levels generally. It would thus be contrary to the national policy, repeatedly stressed by the Congress, to encourage the construction of necessary housing. It would materially add to the economic difficulties faced by this vital industry in the current critical inflationary crisis.

I. Provisions Affecting Home Building Industry

1. Accelerated Depreciation for Residential Housing (Sec. 521(a) of the Bill) -- We endorse the provisions of Section 521(a) which ostensibly recognize the importance of residential housing within the economic structure of this nation by retaining the availability of accelerated methods of depreciation with respect to rental housing. This retention of accelerated depreciation with respect to housing is vital in order to provide the flow of investment funds necessary for construction of such property.

However, the purpose underlying the retention of accelerated depreciation for rental housing is almost completely negated by the interaction of Section 521(a) with the following provisions of the Bill: (i) increase in depreciation recapture (Section 521(b)); (ii) restriction on depreciation by purchaser (Section 521(a)); (iii) limit on tax preferences for individuals (Section 301); and (iv) allocation of deductions by individuals (Section 302).

2. Recapture of Depreciation (Sec. 521(b) of the Bill) -- Under present law, gain on the sale of buildings is taxed as ordinary income to the extent of the depreciation taken on the property after December 31, 1963; however, after the property has been held 12 months, only the excess of accelerated depreciation over straight-line is "recaptured" as ordinary income. The amount of recapture is then reduced after 20 months at the rate of 1 percent per month so that there would be no recapture where the property has been held for ten years.

Section 521(b) of the Bill would amend Section 1250 of the Code to remove the percentage reduction of the amount of recapture. Thus, where a building is sold after July 24, 1969, the entire amount of accelerated depreciation in excess of straight-line taken after July 24, 1969 would be recaptured as ordinary income to the extent of the gain realized on the sale, regardless of the length of time for which the property was held. The effect of such provision would be to apply to real estate depreciation recapture rules which are substantially similar to those applicable to personal property. However, this ignores the fact recognized by this Committee in 1964 that the circumstances of price level changes in real estate are far more severe than occurs in the case of personal property. Asserted gains which occur with respect to realty held for long periods of time often, in fact, represent mere price level changes. In such event, no economic gain, justifying a reversal of a previously granted deduction occurs. This is especially true in times of rapid inflation such as we are now experiencing.

The economic effect of this provision would be to substantially reduce the yield otherwise available from an investment in real estate and thereby impede the flow of necessary capital into the construction of rental housing. Moreover, the enactment of such a provision would produce a significant "lock in" effect, in that owners of existing rental housing would be unwilling to sell the property at any point prior to the end of its useful life (40 years or more), since a sale prior thereto would result in recapture as ordinary income of the entire amount of the excess of accelerated depreciation over straight-line. This is particularly true where the asserted gain arises from mere price level changes. This will have a substantial impact in the case of rental housing held for ten to twenty years. The owner's investment in such property will thus remain non-liquid and unavailable for investment in the construction of new residential rental property which will be necessary to meet the needs of our expanding population at such future time.

3. Restriction on Depreciation by Purchaser (Sec. 521(a) of the Bill) -- The likelihood of a "lock in" effect produced by the full recapture of the excess of accelerated depreciation over straight-line regardless of the period for which the building is held is enhanced by the provisions of section 521(a)(4) which would limit to straight-line the depreciation which could be taken on section 1250 property, including rental housing, acquired after July 24, 1969, where the original use of such property does not commence with the taxpayer.

We are mindful of the fact that under our tax laws, depreciation available to a "second user" of property has been at a rate less than that available to the original user. Under present law, the second user cannot avail himself of the double declining balance or sum-of-the-years digits methods of depreciation on such property, but is instead limited to a maximum of 150 percent of straight-line. Consistent with such past precedent, since the Bill limits depreciation on buildings other than rental housing to 150 percent of straight-line, it would appear appropriate to apply the straight-line limitation to the second user of such buildings. However, since the Bill retains the availability of the accelerated methods of depreciation with respect to rental housing, the proposed limitation on depreciation to straight-line of such property by the second user in fact penalizes rather than encourages ownership of rental housing by curtailing depreciation by the second user at a rate which is in fact greater than the curtailment with respect to the second user of other buildings. Since H.R. 13270 specifically recognizes the economic necessity of a preferred status for rental housing, it is clearly inconsistent therewith to penalize the second user of such rental housing by providing identical treatment to that of the second user of other buildings.

The interaction of increased depreciation recapture and the restriction on depreciation to straight-line in the hands of the second user would have an adverse effect on the housing industry since owners of rental housing will not sell (in view of the substantial depreciation recapture) and potential purchasers will not buy (in view of the limitation to straight-line depreciation on such property). This "lock in" effect will result in channeling of investment funds into more attractive forms of investment and preclude construction of necessary new rental housing in later years.

4. Limit on Tax Preferences of Individuals (Sec. 301 of the Bill) -- The continued availability of accelerated depreciation for rental housing would be further and significantly eroded by the proposed limit on tax preferences ("LTP") which treats the individual's share of the excess of accelerated depreciation over straight-line taken on section 1250 property, including rental housing, as one of several designated "tax preferences". Under this formula, an individual investor who provides equity capital to a partnership for the construction of rental housing would be required to treat as a "tax preference", in each taxable year, his proportionate share of the excess of accelerated depreciation over straight-line taken on the rental housing owned by the partnership. The taxpayer would then determine the total of his "items of tax preference" for such year and the LTP would be the greater of one-half of the sum of (i) the items of tax preference and (ii) the adjusted gross income, or $10,000. The excess of tax preferences over the LTP would be the disallowed tax preference which amount would be required to be added to gross income in determining the taxpayer's taxable income for such year.

The effect of treating accelerated depreciation over straight-line on rental housing as a "tax preference" for purposes of the LTP computation will be to discourage the investment of equity capital required for the construction of this much needed housing. Rather than invest in rental housing with all its otherwise attendant economic risks, an outside investor, faced with additional taxable income in the form of the excess depreciation, will instead channel his funds into other forms of investment which would not generate such additional taxable income, thereby depriving the housing industry of the needed source of outside capital. This will impede rather than permit accomplishment of our housing goals as reflected in the Housing and Urban Development Act of 1968.

Moreover, the potential damage to rental housing is compounded by the failure of the Bill to completely interrelate the LTP mechanism with the previously described increase in depreciation recapture. Assuming, as is most often the case, the rental housing is owned by a partnership, the investor partner may be required to include in gross income under LTP his proportionate share of the excess of accelerated depreciation over straight-line in each year. When the partnership later disposes of the property (e.g., after 12 years), there will be full recapture at ordinary income rates on the excess of accelerated depreciation over straight-line taken by the entire partnership to the extent of the gain realized on such disposition. By operation of the partnership provisions of the tax law, the partnership is a conduit and it is the partners who bear the burden of depreciation recapture.

However, no complete mechanism is provided to permit the investor partner to receive full credit, against his share of ordinary income represented by depreciation recapture upon the disposition of the residential rental property by the partnership,for the amount of ordinary income which he was required to include in gross income under LTP in each of the years during which the partnership held the property prior to sale. The Bill provides that the disallowed tax preferences attributable to accelerated depreciation will increase the "basis of the asset to which they relate" for purposes of determining gain or loss upon the disposition thereof (and not for purposes of computing depreciation thereon). In a factual situation involving a partnership, the "asset" for this purpose would likely be the rental housing itself, so that the investor partner's interest in such property would be increased by the disallowed depreciation required to be included in his income under LTP. (This result is by no means certain since the "asset" in question could be the investor's partnership interest). Under this approach, the partner's share of gain on the disposition of the property by the partnership would be reduced by reason of the increase in his share of the basis of the property. However, since depreciation recapture would be the lesser of gain or the excess of accelerated depreciation over straight-line, the increase in basis will not provide the partner with an offset to depreciation recapture where the gain is greater than the excess of accelerated depreciation over straight-line taken on such property.

The investor partner may thus be required to recognize ordinary income twice on the same dollar of accelerated depreciation, i.e., first, under LTP, in the year in which the excess depreciation over straight-line is claimed on the property by the partnership, and, second, on his share of depreciation recapture upon the later disposition of the property by the partnership. This result would serve to deter the flow of investment funds into rental housing and negate the objective sought to be achieved by retaining the availability of accelerated depreciation for such property.

5. Allocation of Deductions (Sec. 301 of the Bill) -- A further deterrent to investment in the construction and ownership of rental housing is provided in section 302 of the Bill which would require the allocation by an individual of otherwise allowable personal deductions (including interest, taxes, charitable contributions, and medical expenses) and result in a disallowance of the portion thereof attributable to allowable tax preferences, including the excess of accelerated depreciation over straight-line on residential rental housing. The portion of the excess of the individual's share of accelerated depreciation over straight-line for a taxable year which is not disallowed and added to his gross income under LTP is used in determining the portion of such deductions which is disallowed for such taxable year. The portion of the otherwise allowable deductions for such expenses (other than charitable contributions) to be

disallowed by reason of the individual's share of the excess of accelerated depreciation over straight-line on rental housing (and other tax preferences) could not be carried forward and claimed as deductions in a later taxable year.

The effect of the enactment of the above-described provisions would be to impose severe tax restrictions which, together with present financial restraints, would seriously impair the ability of our industry to provide the necessary rental housing for our fellow citizens.

Instead of assisting the home building industry in its efforts to meet the critical housing needs of this Nation, the enactment of these provisions would effectively deter equity investment in the construction of residential rental housing. These proposals (a) penalize the equity investor by utilizing the excess of accelerated depreciation over straight-line on rental housing to result in a double inclusion of income by such investor (through LTP in each year and through increased depreciation recapture in the year of disposition), and a disallowance of personal expenses wholly unrelated to his investment in the rental housing, and (b) create a "lock in" effect as to investment in existing rental housing.

It is therefore imperative that this Committee, recognizing the critical nature of the Nation's housing needs, significantly revise the above-described provisions of H. R. 13270 which would operate to deprive the home building industry of equity capital which is the life blood of its continued operation.

Moreover, we urge that this Committtee reject the recommendation made by the Treasury representatives during their presentation before this Committee to expand the LTP concept to include as a "tax preference" the amount of the excess of interest, taxes and rent over receipts (if any) from unimproved real property during the period of construction of improvements. The Treasury indicated that such amounts are "part of the economic cost of the improvement and when allowed as a deduction result in excessive tax benefits to some high-bracket investors". The treatment of such expenses as tax preferences so as to result in additional income to the investors will serve as another severe deterrent to the flow of investment funds into the construction of rental housing and thereby contribute further to the decline in the construction of such housing.

Such expenses are incurred as integral elements of the overall cost of construction at a time which of necessity is prior to completion of the improvements on such real property and thus prior to the receipt of rental income to be derived from the improvements. These expenses are a necessary incident to the construction of the improvements and should not be subject to penalty solely by reason of the fact that they are of necessity incurred prior to the production of income from the improvements. The treatment of such expenses as a "tax preference" fully ignores the economic realities of the construction of rental housing and other improvements and fails to recognize that the investment of owner is earning no return during the construction period. The excessive tax benefits asserted by the Treasury to result from such expenses are instead an ordinary and necessary part of the construction activity and their effective disallowance (by the treatment thereof as additional income to the individuals) will serve to further preclude the Nation from meeting its commitment for the construction of necessary housing.

6. Rehabilitation Expenses (Sec. 521(a) of the Bill) -- The Bill provides for the depreciation on straight-line method over a period of 60 months of expenditures (having a useful life of 5 years or more) for the rehabilitation of low-cost rental housing, up to a maximum of $15,000 per dwelling unit (apartment). The purpose of this provision is to stimulate and encourage rehabilitation of buildings for low-cost rental housing. NAHB has consistently favored the enactment of a provision of this type in order to provide an incentive for improvement of the living conditions of the economically deprived members of our society.

However, the incentive for such rehabilitation provided by the five-year write-off of rehabilitation expenditures is substantially negated by the inclusion of such expenditures in the computation of depreciation recapture under section 1250. Under Section 521(c) of the Bill, the amount of depreciation recapture upon the sale of low-cost rental housing would include the entire amount of rehabilitation expenditures to which the five-year write-off was applicable or, where the housing was sold after one year, the excess of the depreciation under the special write-off over the depreciation which would have otherwise been allowable on such expenditures, if the useful life had been determined under normal rules. Thus, the owner of such low-cost housing would be required to recognize ordinary income solely by reason of improving the facilities in such low-cost housing.

The inclusion of rehabilitation expenditures to which the special five-year write-off would be applicable within the operation of depreciation recapture is contrary to both the technical requirements of section 1250 of the Code and the purpose underlying special write-off of rehabilitation expenditures. Section 1250 by its terms is intended to recapture only the amount of depreciation which is claimed in excess of the amount otherwise available if the straight-line method were utilized. Section 1250 was never intended, and does not in fact operate, to result in depreciation recapture where depreciation on the building is determined under the straight-line method. Since the special write-off of rehabilitation expenditures expressly provides that it is a depreciation under "the straight-line method" using a useful life of sixty months, there is, in fact, no amount of depreciation in excess of straight-line to which section 1250 should be applicable. Furthermore, since the purpose of the proposed write-off of rehabilitation expenditures is to encourage such expenditures, the fact that the taxpayer will be faced with ordinary income (in the form of depreciation recapture) upon the disposition of such low-cost rental housing will significantly deter his incurring such rehabilitation expenditures and thereby defeat the underlying purpose of the special write-off.

We therefore recommend that the rehabilitation expenditures which qualify for depreciation under the five-year write-off provided in Section 521(a) of the Bill should be excluded from the application of depreciation recapture.

Moreover, we urge this Committee to reject the proposal made by the Treasury during its testimony before this Committee that the rehabilitation expenditures under the five-year write-off be included as a "tax preference" within the LTP concept. The allowance of depreciation on such expenditures over a five-year period was not recommended by the House in order to create a "tax preference" which could result in additional income under LTP as a result of incurring such expenditures, but rather as a recognition of the necessity for a tax incentive to encourage the improvement of existing low-cost rental housing. The potential ordinary income which would result from the combined effect of treating such rehabilitation expenditures as part of LTP and as part of depreciation recapture would produce an "over kill" which would deter the owner of low-cost rental housing from incurring such rehabilitation expenditures and thereby completely frustrate the purpose underlying this provision.

7. Limitation on Installment Sales Provision (Sec. 412 of the Bill) -- We object to the proposed limitation of the election of the installment method of reporting gain to designated "installment transactions" to the extent that such limitation would operate to preclude installment reporting of gain on the sale of unimproved land to be used for the construction of housing, both single family and multifamily. Under Section 412 of the Bill, the installment method of reporting provided in section 453 of the Code would be available only to gain on a transaction in which payments of principal or principal and interest are required to be paid periodically and in such amounts over the installment period as prescribed under regulations by the Secretary. Such requirement will be deemed satisfied if (i) such payments are required to be made at least once every two years in relatively even or declining amounts over the installment period; or (ii) at least 5 percent of the principal is required to have been paid by the end of the first quarter of the installment period, at least 15 percent of the principal is required to have been paid by the end of the second quarter of the installment period, and at least 40 percent of the principal is required to have been paid by the end of the third quarter of the installment period. The

Ways and Means Committee Report provides that this "latter safe-haven rule should protect legitimate installment sale transactions."

We believe, however, that the importance of ensuring the availability of an adequate supply of land for the construction of housing necessary to meet the Nation's housing needs should be given special consideration in qualifying for installment method of reporting gain on the sale thereof. In view of the substantial increase in the cost of land created by our inflationary economy, builders are hard-pressed to arrange for the acquisition of land on terms which are economically feasible. Acquisition of land under such adverse economic conditions requires that the builder have the flexibility to make the acquisition on terms which permit payment over a period of years other than within prescribed percentage limitations while still permitting the seller to report the gain on the installment method. A limitation on the qualification for installment reporting to sales involving periodic payments qualifying within the strict confines of designated percentages as proposed in Section 412 will substantially impede the ability of builders to acquire land for construction of housing which is desperately needed in this country.

We therefore believe that the proposed limitations on the installment method should be amended to expressly exempt therefrom a sale involving unimproved real property where the taxpayer establishes that the property is purchased and will be used for the construction thereon of housing.

II. Provisions Affecting NAHB

Limitation on Deductions of Certain Non-Exempt Membership Organizations (Sec. 121 of the Bill) -- NAHB strongly objects to the enactment of section 121 of the Bill which would limit the deductions incurred by a membership organization in furnishing services to its members only to the amount of income derived from members or from transactions with members. Such provision would, if enacted, severely curtail the performance by NAHB, as a membership organization, of its sole function of furthering the interests of the home building industry. The provision could have the same effect on many of our affiliated local and state associations.

The problem presented by section 121 of the Bill arises with respect to the income derived by NAHB from the conduct of its annual Convention. This Convention, which constitutes one of the largest trade shows conducted in the United States, is undertaken for the sole purpose of educating its members as to the new products and techniques in the home building industry so as to permit its members to construct better and more efficient housing. The income from the Convention is derived from the rental of exhibit space to manufacturers and other organizations directly related to the home building industry which, through exhibits, display such new products and techniques. While a member of NAHB seeing a product which is of interest to him may request to be contacted by the respective exhibitor at a later date, there are no sales transacted at the Convention and it cannot, therefore, be considered as a "sales facility".

Except in the "sales facility" situation, the underlying concept of a "trade show" is that it represents an event designed to permit the interchange of knowledge for the benefit of all of its members. The exhibits represent practical workshops at which the dissemination of information as to new developments and techniques is undertaken in order to educate the members of the industry and increase their technical competence. The "trade show" often makes it possible for members of the industry to become aware of new products and materials which have not otherwise been introduced in their geographical area. In addition, the ability to see the new products and materials in use provides a method whereby the member of the industry can determine the practical application thereof in improving the products or services of such member and his colleagues in the industry.

The non-sales facility "trade show" thus is undertaken for and in fact serves to promote the common business interest of its members through education and information on new products, materials and techniques. Moreover, in most industries, the rapid technological advance which this country has been experiencing makes it imperative that the associations provide such "trade shows" in order that their members be kept abreast of the new developments and techniques in order to effectively operate and thereby improve business conditions in their industry. Indeed, the association conducting such "trade show" would thereby be directly promoting the common business interests of its members and more nearly achieving the purpose for which it was formed.

It is submitted that the proposed limitation on deductions should thus be inapplicable where, as in the case of the NAHB Convention, the income is derived from an activity which "contributes importantly" to the performance by the membership organization of its express function. The purpose of section 121 of the Bill is to preclude the use of investment income to offset the loss from conduct of membership operations. Where, however, the income is derived from the performance of an activity (rather than a passive investment) which is related to the fulfillment of its functions, the membership organization is not in fact utilizing unrelated income to offset operating expenses.

Since the purpose of the Convention which generates such income is directly related to, and contributes importantly to, the performance of the underlying purpose of NAHB itself, there should be no limitation placed on the application of such income against expenses of operation of the organization. Indeed, such result would be inconsistent with judicial decisions permitting such offset and would, in the case of NAHB, do violence to its purpose by impeding its ability to provide its members with a form of services, i.e., the knowledge of the latest techniques and products, which would thereby improve the quality of the housing which this country so desperately needs at the present time.

III. Other Recommendations

1. Investment Accounts for Dealers in Real Estate

We recommend that as part of its consideration of the overall subject of tax reform, this Committee add to H. R. 13270 a provision of vital importance to the home building and real estate industry which would provide for investment accounts for dealers in real estate.

Unlike persons who deal in securities, persons who engage in the realty and home building businesses have no statutory grant (such as provided in section 1236 of the Code for dealers in securities) to earmark realty as investment property, and thereafter dispose of such property as a capital asset.

As a result, the courts have generally precluded home builders from capital gains treatment on realty even under circumstances where the property involved was purchased and sold in an unimproved state. The home builder may prevail under present law only by introducing facts sufficient to establish that such realty was not held principally (or of first importance) for the purpose of sales to customers in the ordinary course of business. The judicial decisions, however, create substantial uncertainty as to the tax treatment of realty acquired for investment rather than for development purposes in a given factual situation.

The purpose of such provision would be to remove the existing uncertainty and create express statutory rules which, if satisfied, would permit an electing home builder to make genuine investments in realty and thereafter dispose of such property with a clear assurance of taxation on the gain thereof as a capital gain. Under this provision, in the case of a dealer in real property, the gain derived from the sale of certain property, could, at his election, qualify for capital gains treatment as gain derived from the sale or exchange of a capital asset.

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Adequate safeguards would be provided in the proposal in order to insure that such provision would be applicable only to realty which was held for investment purposes. The category of real property which would qualify under this provision would be limited to property held by the taxpayer for more than 18 months, on which no substantial improvement (i.e., expenditures of no more than 15 percent of the market value of such property) was made during the holding period, and as to which the taxpayer, within 30 days of acquisition, clearly identifies such property as real property held for investment. The manner of such identification would be prescribed by the Secretary or his delegate.

Legislation generally similar to the above is now part of the Code (section 1236) and applies in the case of securities dealers. NAHB believes that home builders and dealers in real estate should be entitled to the same certainty of tax treatment.

2. Incentives for Housing

This bill presents the Congress with a unique opportunity to provide the people of the United States with improved opportunities for attaining the Nation's housing goals. These goals, set out in the Housing and Urban Development Act of 1968, call for the construction and rehabilitation of 26 million housing units over a ten year period from 1968 to 1978. To meet these goals, it is necessary to produce at an average annual level of 2.6 million housing units. Today we are producing at less than half of that needed average annual level.

The home building industry, because of tight money and excessively high interest rates, is unable to produce anywhere near the volume required to meet these goals and in fact every month is falling further and further behind with an ever declining production level. To encourage the availability of the mortgage money needed to enable our industry to construct the housing needed and desired by the citizens of this country, it is recommended that the following three tax incentives be enacted:

a) Allow a taxpayer to exclude from income the first $750 of interest income on deposits in thrift institutions -- Thrift institutions, primarily savings banks and savings and loan associations, are the primary source of funds for the home building industry. They are finding it increasingly difficult to attract consumer savings because of the competition from other sources offering higher rates than thrift institutions can afford to pay.

b) <u>Give preferred tax treatment to interest income from single family home mortgages</u> -- The single family mortgage instrument in today's economic and inflationary climate has completely lost its attractiveness to investors. The national monetary policies for controlling inflation have fallen with catastrophic impact upon the sources of mortgage funds for single family home mortgages. The Nation can ill afford to have the single family housing industry largely destroyed or curtailed during this current period. Providing preferred tax treatment on the interest income earned on these mortgages is believed fully consistant with the stated National policy of encouraging homeownership. It will also enable this industry to better ride out periods of severe monetary restraint such as we are now in.

c) <u>Condition the continued tax exemption of the income earned by pension, retirement, and similar funds on investment of a percentage of assets in residential mortgages</u> -- Pension funds are the fastest growing pool of savings in the country. The Congress should determine whether their high percentage of investment in equity risk securities is sound and in the long-term public interest. We believe that residential mortgages, now almost completely neglected by pension funds, could and should become a much safer investment resource for pension funds and that conditioning their continued tax exemption on such investment is necessary to achieve this needed shift in their investment emphasis.

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Summary of the Principal Points of the Statement

of

Carl M. Halvorson, President,
The Associated General Contractors of America

The 9000 member firms of The Associated General Contractors of America comprise one of the most significant and most basic of industries. The economic history of the last twenty years amply demonstrates the intimate connection between our health and that of the entire American economy.

As the Congress and the nation undertake this significant reexamination of national tax policy, the members of our association have become increasingly concerned over the multiplicity of recessive measures, not fully thought through in terms of the tax policy, whose primary effect will be upon the construction business.

Existing Depreciation and Recapture Rules
Should Be Retained for All Real Estate

Section 521 of H.R. 13270 would deny all accelerated depreciation to used property and restrict depreciation of new nonresidential property to the 150 percent declining balance method.

In doing so Section 521 ignores that the greatest economic wastage of real property occurs in the early years of ownership, and that double declining balance and sum of the years-digits depreciation are necessary to allow recovery of this capital shrinkage. Although opponents of accelerated depreciation rely on data which shows resale prices in excess of adjusted basis, this spread is true capital gains, fully accounted for by the immense inflation in construction costs -- more than 30 percent in the last five years and 15 percent just since January 1968 -- and by the growing scarcity of urban land. The cash flow produced by depreciation -- the other factor said to support Section 521 -- is amply justified by the need to service mortgages in an ever tightening money market and the needs for reserves which are constantly used to renew the property.

Section 521, furthermore, misses the abuses at which it is supposedly aimed. For sound reasons apart from tax policy, new residential construction is exempted from the proposed strictures on accelerated depreciation, even though it is such real estate that is most open to the rapid turnover which is the key to any tax abuse. This part of Section 521 would apply only to industrial and commercial structures, where the opportunities for abuse are negligible and where restrictions on depreciation will greatly decrease the ability of American business to meet foreign competition. Indeed, in this respect Section 521 is directly at odds with the approach of Section 221 of the House bill. That part, in establishing limitations on the interest deduction, recognizes that expenses incurred in a trade or business are not susceptible to abuse and expressly exempts interest incurred in the conduct of a trade or business.

Nor has any cogent case been made for the recapture rules that Section 521 would impose. We did not oppose the adoption of Section 1250 in 1964 because we believed then and believe now that it provides a rational and fair inhibition upon the tax abuse that can exist in this area by measuring the recapture of depreciation into ordinary income by the length of the taxpayer's holding period. Section 1250 presents a carefully designed tool that is entirely responsive to the difficulties that existed. H.R. 13270, on the other hand, would convert all depreciation above straight line to ordinary income upon the sale of real estate, and thereby penalize a bona fide long term investor who has not abused the tax laws and seriously restrict the amount of capital that will be placed into construction of modern facilities.

The Need For Reform of Capital Recovery Rules

The most notable and most serious omission from H.R. 13270 is the absence of the long promised general reform of our capital recovery system. Against the background of the proposed repeal of the investment credit, this reform is more necessary than ever.

The cost of machinery is a major factor in the construction industry, and the five year life applied to most of our equipment ignores the extraordinarily abusive working conditions and rate of technological change that makes our equipment substantially useless after a year or two of use. For much of the last several years, the investment credit has compensated for the unrealistic useful lives applied in our industry. If, contrary to the repeated assurances we have heard in prior years, the credit is not to be a permanent part of our tax structure, there must at the same time be a general reform of capital recovery rules for all industry.

That reform must recognize three principles.

First, average lives must be based upon the optimum practice for each industry. Otherwise the tax code will forestall industrial modernization and build obsolescence into American industry. All American business will suffer an increased disadvantage in competing abroad, where rapid capital recovery has long been a principal tenet of tax and economic policy.

Second, depreciation rules must recognize that some taxpayers have a particular need for rapid replacement. Now that the moratorium on the reserve ratio test is ended, revenue agents will see themselves free to renew the endless haggling over depreciable lives that marked audits for so many years, unless the Congress emphasizes that a businessman's reasonable decision of how to manage his own business should be given the strongest weight.

Third, changes in the depreciable lives must not be viewed as revenue gathering or contracyclical devices. For thirty years our economy was hampered by restrictive depreciation rules based on a depression decision to raise more money by lengthening useful lives. This is poor tax policy and disastrous economics. Depreciation reform should provide a context that invites steady capital investment and provides an assured permanence of statutory structure.

The specifics of depreciation reform should start with four proposals which the machine tool industry previously described for this committee.

Two, elimination of the reserve ratio test and the amendment of Section 167 to eliminate the need to establish salvage value, would simplify tax accounting, eliminate endless controversies on audit, and recognize that in the construction business as elsewhere there is no predictable or readily available salvage market for many capital goods.

The third proposal, to codify the guideline depreciable lives, is highly meritorious, but the Congress should recognize (1) that the guidelines are unnecessarily restrictive in their treatment of the construction industry; (2) that three years rather than five years is a realistic average life for construction equipment; and (3) that some contractors in some situations require even shorter lives.

The fourth proposal -- to eliminate the $10,000 ceiling upon the additional first year depreciation allowance of Section 179, with a possible reduction in rate -- would help compensate for the loss of cash flow that will follow repeal from the investment credit. An amendment of Section 179(d)(1) to grant the allowance without regard to the useful life of depreciable property would be particularly equitable in its application to the construction industry.

Interest on the Obligations of State and Local Governments Should Remain Tax Exempt

A significant portion of the business of members of our association consists of public construction. By disrupting the financial market for state and local securities -- and the financial press shows how severely the House passage of H.R. 13270 has restricted the marketability of these securities -- the inclusion of interest on these obligations within the tax preference provisions of the bill will destroy the ability of local governments to supply necessary facilities and services.

We agree that each American should pay some taxes on his economic income. It is incorrect, however, to include interest on state and local securities in the catalog of items not carrying their fair tax burden.

The holder of these securities pays a silent tax, measured by the difference between the interest he receives and the greater interest available on nonexempt securities. Interferences with the tax exempt status of public securities will require a compensating increase in state and local taxes, and there will not be commensurate increases in federal tax collections. This "reform" will increase everyone's taxes and decrease no one's; there is no justification for its enactment.

The Existing 5 Percent Depletion Rate for Sand and Gravel Should Not Be Reduced

For reasons that are unexplained, H.R. 13270 would impose a 20 percent reduction in the smallest depletion rate in the tax code: the 5 percent rate accorded sand and gravel.

Sand and gravel producers face a staggering need to find and develop new supplies in the last third of this century. The average annual output must be doubled to satisfy projected demands. Cost of development and production are particularly high, since deposits must be developed near construction sites and their proximity to metropolitan areas requires extensive expense for rehabilitation after the sand and gravel is removed.

The proposed reduction in depletion rate can only increase the cost of construction contractors, who are the primary consumers of sand and gravel. Both considerations of tax policy and the economics of an industry that has already suffered immense inflation in cost require continuation of the 5 percent rate.

The "Country-By-Country" Limitation on Foreign Tax Credit Should Not Be Changed

Section 431 of the House bill would impose an additional inhibition on the ability of smaller businesses -- those who lack a large base of foreign income -- to compete abroad. The danger perceived -- the possibility of a double tax benefit for those who have loss years followed by successful years in foreign countries -- exists only for activities in countries not allowing loss carryovers in their tax structure.

But the effect of the denial of the carryover is to increase the effective tax rate in those countries, and the limitation of the American tax credit in turn would increase the effective total tax burden beyond the amount the American tax code would impose on the net results of the foreign business. Thus, this provision not only would impair the United States' position in foreign commerce, but it also would frustrate a prime function of the foreign tax credit.

H.R. 13270 Would Subject the Construction Industry To a Multiplicity of Recessive Yet Inflationary Pressures

Each of the parts of H.R. 13270 which I have discussed would inhibit new construction, raise the cost of construction, or both. H.R. 13270, if not changed, will subject the construction industry together with the entire economy to a multiplicity of pressures that are both recessive and inflationary. These parts of H.R. 13270 are not sound as tax reforms, they are economically dangerous, and they should not survive the scrutiny of the Senate.

Statement of Carl M. Halvorson, President,
The Associated General Contractors of America

Before The
Senate Finance Committee
on H.R. 13270

September 26, 1969

My name is Carl M. Halvorson, and I am a general contractor in Portland, Oregon. I appear before the Finance Committee in my capacity as President of the Associated General Contractors of America.

The Associated General Contractors, as our name suggests, is a trade association of construction contractors. We have about 9,000 member firms who come from all fifty of the United States, the District of Columbia, and Puerto Rico. Our business includes all manner of heavy construction; our members build about 75 percent of the contract construction in the United States. I need not dwell at length on the place the construction industry has in the American economy. We are among the most basic of industries. The health of the construction business is essential not only to the contractors of our association and their employees and suppliers, but as well to every economic activity in the Nation.

We appreciate the Committee's courtesy in extending to us the opportunity to express our views on H.R. 13270. This, of course, is one of those periodic occasions when our country re-examines and reassesses its tax policies. The decisions of this Congress will establish national tax policy for many years to come. This consideration, above all else, causes us to view with no small measure of alarm five pending tax proposals, which we believe are poorly founded as a matter of tax policy, inconsistent with a goal of orderly economic growth, and unusually discriminatory in their cumulative impact upon the business of the members of our association.

Existing Depreciation and Recapture Rules
Should be Retained for all Real Estate

Section 521 of H.R. 13270 makes two important changes in the depreciation of real property which are the source of our gravest concern about H.R. 13270. Above all other provisions of this Bill, Section 521 will inhibit the formation of new capital for investment in construction and have a serious recessive effect upon the economy.

The first change would deny accelerated depreciation to used property and restrict depreciation on new nonresidential property to the 150 percent declining balance method. The double declining balance and the sum of the years-digits methods would be forbidden. In addition, the Bill would require that all accelerated depreciation taken on all buildings after July 24, 1969, be converted to ordinary income when the building is sold. These changes do not constitute rational tax policy and do not respond to the supposed evils that are cited in their support.

The proposals are premised on the abuses which can occur upon the use of accelerated depreciation followed by rapid resale of real property. We all know that this combination presents an opportunity for the deferral of ordinary income and its conversion to capital gains. Such tax avoidance devices were becoming common at the time Section 1250 was added to the Internal Revenue Code in 1964 for the purpose of restricting capital gains treatment of accelerated depreciation to owners who held property for a reasonably long period of time. The general approach of Section 1250 is a rational and fair one and we did not oppose its enactment. But we believe the present proposal suffers from a host of defects.

First, it is economically unsound to conclude that only straight-line depreciation reflects economic wastage. The greatest risk of loss and the greatest physical deterioration occur in the early years of ownership.

The initial owner -- the person who puts up the capital to construct a facility -- takes these risks. At no time since the adoption of accelerated depreciation methods in 1954 has anyone produced persuasive evidence to indicate that this is not so or that double declining balance and sum of the years-digits overstate the economic wastage inherent in these initial risks.

Historically, two factors have been relied on by those who nevertheless argue for elimination of these methods. First, they point to resale prices, which generally exceed adjusted basis. Second, they point to the existence of cash flow in excess of the amount needed to service the mortgage. Although both premises are repeated in the House report, each is fallacious.

Comparison of resale prices to adjusted basis fails to take account of inflationary pressures on real property values. Enormous increases in costs of land, labor, and materials have inflated property values even beyond the general rate of inflation. This is reflected in the report which the Bureau of the Census issued this month entitled "Value of New Construction Put in Place."*/

*/ Construction Reports, Value of New Construction Put In Place July 1969 (issued September 1969), United States Department of Commerce Publication C30-69-7.

That report, in evaluing recent construction in terms of 1957-1959 dollars, shows an inflation of over 40 percent in the last ten years. Construction costs have increased by 30 percent since 1964 and at least 15 percent just since January 1968.*/ Thus, a building built in 1964 should have increased in value by at least 30 percent to keep pace with the inflation in building costs. The squeeze on urban land should increase the value even more.

It is, therefore, not surprising that resale price often exceeds adjusted basis. But this only proves the great inflation we have suffered in the last five years. It does not show that accelerated depreciation methods are now overly generous. Rather the increases in property value are true capital gain because they represent a true increase in the dollar value of the invested capital, an increase caused by the combination of inflationary pressures and the growing scarcity of land.

Insofar as the excess of cash flow is concerned, the first critical point is that the tighter money becomes, the smaller that excess is. The second point ignored in the House is the need of a cash reserve for repairs and maintenance. The creation of such a reserve is the prime

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*/ See Tables 2, 3, and 18 of Publication C30-69-7.

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economic function of depreciation, and, in a soundly managed operation, the reserve is constantly being used for renewal of the property.

My next point is that the real estate provisions of this Bill are not responsive to the abuses its sponsors claim to perceive. Rapid turnover is the key to any tax abuses which exist. The feared deferral and conversion of ordinary income occurs only if the property owner holds real estate for a short period of time and resells it without making the repairs necessary to account for the physical deterioration occurring during his ownership. This abuse is most readily achieved and most commonly occurs in residential property. For purposes of national policy with which we agree -- to encourage the badly needed expansion of the housing supply -- H.R. 13270 exempts residential structures from the proposed restrictions on accelerated depreciation. The tax consequence, however, is that the double declining and sum of the years-digits depreciation would continue to be available in the area that is most susceptible to abuse and would be denied only to industrial and commercial structures, where rapid turnover is not as likely and long-time ownership is the rule.

Oddly enough, this treatment is exactly the opposite of that provided in Section 221 of the Bill, which limits the deduction of interest on loans used to carry investment assets. Section 221 directly recognizes that expenses incurred in a trade or business do not lend themselves readily to abuse, and interest paid in the conduct of a trade or business is exempted from the limitations established in Section 221.

The same approach should be applied to real estate. Industrial and commercial facilities do not invite turnover and do not allow postponement of repairs in the manner of residential housing. They are simply not the proper target for restrictions on accelerated depreciation.

The restrictions of Section 521 would also increase the competitive disadvantage American business experiences in foreign markets. Tax structures abroad place high priority on the rapid recovery of capital investment, even allowing depreciation writeoffs substantially in excess of economic wastage. America must compete for the construction budgets of domestic and foreign industries, and the inevitable result of Section 521 would be to encourage domestic capital to go abroad, and foreign capital to remain beyond our boundaries.

These factors all show the unreason of restricting the depreciation available to industrial and commercial facilities. Since there are other sound reasons for not applying this part of Section 521 to residential housing, it simply should not be enacted.

The recapture provisions of Section 521 are equally unjustified. This part of the Bill and the existing provisions of Section 1250 of the Internal Revenue Code are both intended to inhibit the rapid turnover that facilitates the use of accelerated depreciation to convert ordinary income into capital gains. Here, however, the similarity ends. While Section 1250 uses the carefully designed method of measuring the recapture of depreciation into ordinary income by the length of the taxpayer's holding period, Section 521 would recapture all accelerated depreciation, whatever the length of the taxpayer's holding period.

The hearings and the reports are entirely devoid of any justification for this change. There is no demonstration that Section 1250 has worked badly and there is no reason to believe that it has. Surely, Section 1250 should be left as it is until there is acceptable evidence that the statute still leaves room for abuse.

But if the rules are to be changed, the basic structure of Section 1250 is the only one consistent with sound tax policy. All should agree, I believe, that the man who holds real property for ten years is not the source of tax abuse. The problem is to determine the minimum holding period necessary to deter avoidance. We believe that the twenty month minimum now established in Section 1250(a)(2) is long enough, since the section retains a prorated recapture for holding periods between twenty months and ten years. If the Congress concludes, however, that abuse still exists, it would not be a fair or rational solution to penalize the bona fide long term investor as H.R. 13270 would. The proper response would be to extend the minimum holding period, while adjusting the rate of recapture */ to retain ten years as the holding period when recapture ceases to apply. **/

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*/ If, for example, the minimum holding period were extended to 36 months, 1.2 percent per additional month of ownership would then represent an appropriate adjustment to recapture.

**/ In addition to these difficulties, the recapture provision of the new Bill is most inequitable. Real estate is a relatively risky and nonliquid investment. Persons placing money in real estate must plan for a relatively long period. The amount of depreciation available and the presence or absence of recapture is one of the determinants that influences the investment decision. This Bill changes the rules in mid-stream for all existing or committed real estate, since the recapture rules apply to depreciation attributable to periods after July 24, 1969, regardless of the acquisition date.

The Need for Reform of Capital Recovery Rules

We recognize that today is not the appropriate time to present testimony relating to the proposed repeal of the investment credit. I must, however, start with that as background, for heavy machinery is one of the major costs in our industry, and repeal of the investment credit without adoption of long needed reforms or our capital recovery system will impose a substantial and unwarranted tax increase upon our industry.

Most of our machinery and tools are now treated as having a five year useful life. Superficially this appears to be generous. When viewed against the demands of the construction business, however, this rule, which revenue agents refuse to vary on audit, ignores the actual shorter useful lives of our equipment and therefore artificially exaggerates the true income of the construction business.

The purchase price of construction equipment is high, yet its useful life is relatively low. It is worked hard and it is worked out of doors under widely varying conditions. The life of this equipment is shortened by differences in the competence of operators, the unavailability of proper maintenance in the field, and the inherent difficulty of excavation and other aspects of construction work. For any one contractor, the useful life of his equipment varies with the type of work he does and the abilities of the men in his employ. The same machine may be useless after six months on one kind of job, but have a life of several years in other work. Our continuing need to find and accept technological change further quickens the obsolescence of our tools and equipment. And to compound these difficulties, many members of our association are called upon to do specialty and nonrecurring work which requires equipment that is useful only to that contractor and only on that job.

The end result is a great need for depreciation rules realistic enough to accommodate the unusual circumstances of our industry. The five year useful life now generally applied to us*/ is not a reasonable expectation for the average piece of construction machinery. The use of this life has denied us deductions that reflect true costs of operation. The investment credit has helped

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*/ The far longer 12 year life applied to equipment designed for maritime construction constitutes an extreme imposition upon the economics of the construction industry. In addition to all the problems of land based construction, maritime equipment is exposed to unusually inhospitable and corrosive working conditions. It should have no longer a depreciative life than land equipment, and often should be depreciated over its use in a particular job.

compensate for this defect, so long as it has existed. If the Congress now allows the administration to withdraw from the repeated assurances that the investment credit would be a permanent part of our tax structure, then it is essential that the Congress at the same time provide a general overhaul of our capital recovery structure.

I emphasize that we do not seek specific relief for the construction industry. Rather, we see our problem as one facet of a general pattern of unrealistic tax depreciation rules which repeal of the investment credit will impose on business. We believe that adjustments to the rules for our industry should be part of a general reform of the capital recovery structure.

That reform should begin with recognition of three essentials of any rational capital recovery policy.

First, depreciation lives must be based on the best practice which recognizes the problems inherent in each taxpayer's business. Whatever average lives are used as benchmarks must account for and depend upon the best practice for the industry. A technological revolution is fully upon us, in an unprecedented sweep. In construction and every other business, scientific invention speeds progress beyond prediction; equipment becomes obsolete and requires replacement with amazing frequency.

Unless depreciation lives are consistent with optimal replacement practices which keep pace with technology, the tax code will build obsolescence into American industry. Here again, American business would be disadvantaged in foreign competition. American firms seek construction jobs abroad; success benefits the American economy, while diminishing balance of payment and gold flow problems. The principal foreign industrial nations, as a foremost matter of tax policy, provide depreciation methods designed to give the maximum possible incentive to renewal of capital equipment. We cannot compete meaningfully abroad unless depreciation reform in the United States eliminates our continual lag behind the practices of other countries and provides us with the cash flow necessary to maintain a competitive technology.

Second, depreciation reform must recognize that some taxpayers must replace equipment even more rapidly than the industry optimum. This is particularly so of the construction business. Up to the early 1960's, the construction industry, more than any other, suffered continual harrassment from Internal Revenue agents who refused to recognize the depreciation problems of individual contractors. Now that the moratorium on the application of the reserve ratio test has ended, we have every reason to expect a renewal of hostility on the part of auditing agents. The need for a realistic approach on audit will be even greater if the investment credit is lost, yet repeal of the credit may well serve to encourage the Internal Revenue Service to return to practices that for thirty years inhibited capital investment. Depreciation reform must therefore reiterate that the special problems of individual taxpayers must be recognized; a businessman's reasonable decision of how to manage his own business should be given the strongest weight.

Third, changes in depreciation lives must not be viewed as a revenue gathering or contracyclical device. Ever since Bulletin F was adopted during the Great Depression, the tax collector has been tempted to raise more money by lengthening useful lives. This very thought was suggested this year as one of the reasons for changing the rules for real estate depreciation. This approach runs counter to every basic of rational tax policy. As a matter of economic policy, it invites disaster. The question is one of confidence. Orderly economic growth requires a climate for orderly capital investment. The planning which must underly rational investment is impossible if depreciation rules are hostage to unpredictable change. Only meaningful depreciation reform, in a context which provides permanence of structure, can restore the confidence shaken by a retraction of the assurances that the investment credit was here to stay.

The specifics of depreciation reform should start with the proposals offered to this Committee on September 11 on behalf of trade associations representing the machine tool industries. Two of the proposals, elimination of the reserve ratio test and the amendment of Section 167 to eliminate the need to establish salvage values, would simplify tax accounting and eliminate endless controversies of no lasting significance with revenue agents. The elimination of salvage values is particularly essential to our members, for the economic fact of life is that these values are generally nil in the construction business, and for many of our items there is no predictable or readily available salvage market.

We also agree that the guideline depreciation lives of equipment should be codified, but with recognition of the economic realities of the construction business. Three years rather than five years should be established as a realistic life for construction equipment, and the codification should expressly allow for those instances where the practices of particular taxpayers require shorter lives.

The fourth proposal was that Section 179 be amended to eliminate the $10,000 ceiling upon the additional first year depreciation allowance, with a possible reduction in the rate of that allowance from 20 percent to 15 percent. Such a change would be particularly equitable if applied to the construction business. Therefore, we urge that Section 179(d)(1) be amended to allow the application of the provision to depreciable property without regard to its useful life. As short lived as our equipment is, the greatest amount of wear and tear occurs in the first year of use. A great amount of the equipment is virtually useless and unsalable at the end of the first year. Such an amendment would help compensate for the loss of cash flow that would follow repeal of the investment credit, cash that is necessary to enable us to keep our tools and equipment modern and usable.

Interest on the Obligations of State and Local Governments Should Remain Tax Exempt

A significant portion of the business of members of our association consists of public construction. That construction depends on the existence of regular and orderly financial markets where local governments may market their securities. The experience of the money markets over the last several months demonstrates that unfortunate portents for public finance inhere in the inclusion of interest on the obligations of state and local governments within the definition of tax preference items in Section 301 of H.R. 13270.

We do not disagree with the basic purpose of Section 301 -- to require each American to pay some tax on his economic income. We dispute, however, the inclusion of interest on state and local obligations as an item that does not bear a fair share of the national tax burden.

As a formal matter, the holder of these obligations pays no tax on his interest income. As a consequence of the present tax exemption, however, the holder receives a lower yield. In substance, he pays a silent tax measured by the difference between the interest he receives and the greater interest available from securities not enjoying an exemption.

In addition, unlike the other items included in the definition of tax preference, this is not a situation where the elimination of one man's exemption will decrease his fellow citizens' taxes. The obvious and expected effect of the proposed legislation will be a significant increase in the yields on state and local obligations. That increase must be satisfied through increases in the taxes imposed by the issuer of the obligation. And it is not realistic to expect that the Federal taxes paid by purchasers of these obligations will exceed the additional burdens being placed on state and local taxpayers. It is more likely that high bracket taxpayers will take their money out of state and local securities and place them either in other tax exempts or in situations that offer a potential for capital gains. This is already being demonstrated, for nearly every day the financial press reports instances of the difficulties state and local governments have been having in borrowing funds since the House passed H.R. 13270. Thus, this is a so-called "reform" that will increase everyone's taxes, and decrease no one's, achieving all this while diminishing the ability of state and local government to provide needed facilities and services.

The Existing 5 Percent Depletion Rate For Sand and Gravel Should Not be Reduced

The proposed 20 percent reduction in depletion on sand and gravel is the fourth aspect of H.R. 13270 of concern to the construction industry. Sand and gravel now have the smallest depletion rate in the tax code: 5 percent. In contrast to most minerals, depletion rules provide sand and gravel with a less favorable method of capital recovery than would be available if the ordinary capital gains treatment were available. Nevertheless, Section 501(a) of the House Bill would reduce this modest depletion rate to 4 percent.

The House Report focuses on petroleum. It fails to offer a single word of explanation or justification for changing the rate for sand and gravel. This smallest of depletion rates seems to be a victim -- perhaps an unintended victim -- of the emotions stirred by oil and gas depletion rates.

We in the construction industry are the primary consumers of sand and gravel. It is a basic construction commodity. The demands for it are enormous. Production now exceeds 900 million tons annually. As large as that is, the United States Bureau of Mines, in a study entitled "Cumulative Demand Projections For Sand and Gravel," projects a demand during the last thirty years of the twentieth century "in the range from 57.2 to 65.6 billion tons." This means that the annual output of sand and gravel must be doubled during the last third of this century, even though a study conducted in 1963 showed a life expectancy for reserves of only 24 years.

In consequence, sand and gravel producers face a staggering need to find and develop new supplies between now and the year 2000. Furthermore, the high costs of transporting this material requires that deposits be developed near metropolitan areas; this in turn adds further to the cost, for the proximity of the site to urban areas requires extensive cost for site rehabilitation after the sand and gravel is removed.

This, I submit, constitutes the strongest of cases for not lowering the already low depletion rate for sand and gravel. The proposed reduction in rate can only increase the cost of sand and gravel and thereby increase the cost of construction. The construction industry is already suffering from a rate of inflation far higher than the national average. Here H.R. 13270 would add to that inflation without the slightest justification in tax policy or economics.

The "Country-By-Country" Limitation on Foreign Tax Credit Should Not Be Changed

Section 431 of H.R. 13270 would impose an additional burden on United States contractors who seek to do business abroad by imposing new restrictions on the "country-by-country" foreign tax credit. The hardship would be particularly severe for the contractor least able to bear it -- the one doing his initial work overseas or who has a limited amount of overseas work in only a few countries. He is the one who normally uses the country-by-country limitation, since he lacks the large base of foreign income available to companies with more developed business throughout the world. The effect, moreover, would be particularly magnified in its influence on the balance of payments, for these are the same businessmen who most tend to repatriate investment and profit.

The asserted justification for the proposed changes is that a United States' taxpayer with losses in a foreign country may receive a double tax benefit if, in the year of the foreign loss, he offsets it against domestic income, and then in a better year takes a credit for foreign taxes. This danger, however, is mostly theoretical, and where the danger is real, the effect of H.R. 13270 would be to impose a form of double taxation on American businesses doing business abroad.

The asserted double benefit cannot be realized in respect of activities in countries which provide for loss carryovers in their tax laws, since the taxpayer sets off losses before taxes become due to the foreign authority. The problem can only arise in those countries, usually undeveloped, which do not allow loss carryovers in their tax laws. The result in those cases is an increased

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effective tax rate in profitable years. The existing United States law allows a taxpayer to mitigate the impact of this increased effective rate by the use of foreign tax credits. This well serves the function of foreign tax credits -- to allow United States business to conduct international trade in a climate where the combined foreign and domestic tax burden does not exceed the United States rate. Because the proposed change in the country-by-country credit would apply only where the foreign country imposes an increased effective rate, H.R. 13270 would create a form of double taxation by imposing a total tax burden in excess of the United States rate.

We strongly urge that this limitation be deleted because its impact will be on smaller business and the result will be a deterioration of the American position in foreign markets. If it remains, however, it should be amended so that the United States "recapture" will not bring the total foreign and United States taxes above what the United States taxes would have been if the foreign operations in all the years in issue had been carried on in the United States.

H.R. 13270 Would Subject the Construction Industry to a Multiplicity of Recessive Yet Inflationary Pressures

To this point in my presentation, I have focused on specific aspects of H.R. 13270. Now I should like to view them from the perspective of the Bill's overall impact on basic construction.

The changes in rules for depreciation and the changes in the tax exempt status of interest on state and local obligations will serve to decrease the amount of new construction. At the same time both changes will increase the costs to users of new property. The repeal of the investment credit without compensating depreciation reforms and the reduction in depletion on sand and gravel will directly increase our costs. The Bill also would impose new and serious impediments to the investment of foreign capital in the United States and to the ability of American businesses to compete in foreign markets. Tight money and construction cutbacks have yet an additional negative impact on our industry.

The Bill then has the recessive effect of inhibiting construction while at the same time adding to inflationary pressures. Each of these aspects of the Bill feeds upon and re-enforces the other, and they are further multiplied by the other contracyclical measures the Administration has taken. Although H. R. 13270 is called a tax reform bill, the features I have discussed here simply cannot be justified as attacks on demonstrated abuses. They are poorly conceived, dangerous to the American economy, and should not survive the scrutiny of the Senate.

SUMMARY OF TESTIMONY OF LEON H. KEYSERLING*
IN PART REPRESENTING REALTY COMMITTEE ON TAXATION
AND IN PART AS INDEPENDENT ECONOMIST
SENATE FINANCE COMMITTEE
FRIDAY, SEPTEMBER 26, 1969

Mr. Chairman and Members of the Committee:

General considerations

I appreciate this opportunity to add to your consideration of one of the most momentous economic and financial measure in many a year. The Bill in its present form contains many essential and desirable provisions. But I shall concentrate upon what I regard to be the need for improvement, as that should be most constructive and helpful to this Committee. Clearly implied in these comments will be my attitude toward those provisions which appear to me to be sound and good.

The major portion of my testimony relates to general economic and financial considerations and their bearing upon the general provisions of teh Bill, because I am profoundly convinced that we all tend to pay too little attention to these ultimate matters when considering tax proposals. In these phases, I appear independently, as I have so many times previously before this Committee. My specialized comments bearing upon the provisions of the Bill dealing with housing and other real estate investment is made on behalf of the Realty Committee on Taxation, although my conclusions in this area are also arrived at independently, and I hope objectively.

The past is prelude, and my previous testimony before this Committee and elsewhere on the massive tax cuts and concessions of 1962-1965 is highly relevant to the current Bill. I felt in the years gone by that these massive tax cuts and concessions were grievously misdirected in large degree. They surrendered too much Federal revenues, in terms of national and international needs dependent upon public spending; misallocated resources between investment and consumption so as to impair

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economic equilibrium and work against maximum economic growth, production, and employment; and aggravated inflation and the balance of payments problem by ignoring the real causes thereof. On both economic and social grounds, they helped too much those who needed help least, and helped too little those who needed help most, both on the individual and business entity side.

I submit that the more recent developments have very substantially vindicated my earlier concern. Although inflation is now rampant, our real rate of economic growth since 1966 has been much too low, is much too low now, and this in itself aggravates rather than curbs inflationary pressures, and adds to unemployment. The most urgent of our domestic priorities are being relatively neglected. Fiscal policy is still highly contributory to resource misallocation. The current Bill, if properly corrected, affords a tremendous opportunity to use the mighty weapon of fiscal policy to learn by experience, correct the errors of the past, and put us on the right course.

But the Bill in its current form, in very large measure, does not do this. On equitable grounds, it makes a highly improper distribution of tax relief, especially when added to the gross inequities of the 1964 measure in this respect. On economic grounds, it does not go nearly far enough in the direction of redressing the imbalance between investment and consumption. Its specialized or <u>ad hoc</u> provisions discriminate against those lines of endeavor which need most to be stimulated greatly, most especially housing and supportive nonresidential construction investment, while dealing lightly or even favorably with lines of endeavor which have been and now are running relatively much too fast.

<u>Misallocation of investment provisions of the Bill</u>

Specifically, excluding the tax reforms, the House Bill does not appreciably affect net investment allocations as affected by tax policy, and the Treasury proposal increases them by 1.1 billion dollars. This is ironical, in view of the proposal to repeal the investment tax credit on the ground that investment in general is grossly excessive. Even with the reforms, the House Bill reduces the allocation to investment as affected by tax policy by only 3.9 billion dollars, and the Treasury proposal by only 2.5 billion. This is not nearly enough. I favor a tightening up on the net allocation to investment as affected by tax policy by about 6 billion dollars, which would leave much more room for reconsideration and revision of some of the provisions bearing down upon the tightening up of investment upon housing and also nonresidential construction, for reasons which I shall subsequently disclose.

<u>Inequitable features of personal tax cut provisions</u>

The inequitable features of the current Bill, also highly undesirable from the functional economic viewpoint, are as follows: Without the reforms, neither the House Bill nor the Treasury proposal gives more than 10.5 ~~8.0-11~~.8 percent of the personal tax cuts to those with incomes up to $5,000 who constitute 47.0 percent of total returns, while they give 13.4-17.2 percent to those with incomes of over $50,000 who constitute only 0.4 percent of all tax returns. The distributions between these two extremes are subject to the same type of inequity. I believe that the provisions viewed without reforms are more important than those viewed with reforms. The reforms are more debatable and uncertain of enactment; they do not impact equally upon all those in any given group; and we know from experience that, if the reforms are modified or mutilated, the regular rates do not tend to be adjusted accordingly. But even with the reforms, the distribution of the tax cuts is highly inequitable.

And by the far more meaningful test of effect upon after-tax or disposable income, the House Bill with or without the reforms increases such income by less for those from $5,000 to $20,000 than for those with incomes from $20,000 to $50,000. Without the reforms, the House Bill increases disposable income by immensely more for those over $50,000 than for any other group. The Treasury proposal is far more regressive in these respects. Even with the reforms, by this vital test, both the House Bill and the Treasury proposals are not nearly progressive enough, especially in view of the imperative need to counteract in part the highly regressive features of the 1964 tax cuts. This imperative need is best illustrated by the fact that, taking all forms of nationwide taxation into account, those with incomes between \$3,000 and \$4,000 pay a higher share of their incomes in total taxes of all kinds than any other group up to \$15,000, and almost as high a share as those with incomes between \$15,000 and \$20,000. Those still higher up, by all equitable tests of progressivity, do not pay a sufficiently higher proportion of their incomes in taxes of all types.

All things considered, I suggest not reducing at all the personal tax rates, before reforms, of those with incomes of \$50,000 and over, and I seriously question whether there should be substantial, or perhaps even any, such reductions for those at \$20,000 and over.

The amounts thus saved should be used for further reductions for those lower down in the income structure, with emphasis on progressivity.

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General comments on defects in provisions relating to housing and nonresidential construction investment

The extent to which the foregoing provisions of the Bill depart from desirable allocations of tax changes, both on economic and social grounds, are paralleled by comparable departures with respect to the more specific or ad hoc features of the Bill, especially those bearing upon housing and what I regard tp be the intimately associated factor of investment in nonresidential construction. And because our economy and the problems of our people are a seamless web (and so is fiscal policy), the generalized and specialized departures from desirable tax changes have mutual and cumulative effects.

The widespread impression that the Bill draws a sharp dichotomy between housing and nonresidential commercial construction investment is erroneous. As I shall disclose, the preponderance of the provisions of the Bill inimical to real estate generally are also inimical to housing.

Even more important, we are here again dealing with a seamless web. Urban rescue and renewal do not depend upon housing alone. Housing, especially for the poor and others of low income who cannot move out of cities, is intimately associated with and supported by commercial structures -- stores, community and recreational facilities, and professional space.And investment in all of these can provide vast expansion of employment in sectors where such expansion is essential in the years ahead, to counteract the trends toward technological displacemnt in other key sectors.

The alarming long-term decline in housing and nonresidential construction investment, especially when related to current and future national needs

The data which I shall now present demonstrate the absolute contrast between the severe and prolonged deterioration in these vital sectors and the provisions of the Bill designed to provide them with even less tax incentives than they now have. This, although on all sides, including other long-range Federal programs involving scores of billions of dollars over the years ahead (in declarations of Congressional intent, but not in actual appropriations), we have been proclaiming that the rescue and renewal of our urban areas is our most critical domestic priority.

Private nonfarm housing starts declined, on a seasonally adjusted annual basis, from 1,845 thousand units in January 1969 to 1,314 thousand units in July, or 28.8 percent, and the end is not yet. The ratio of housing and commercial construction investment (combined) to GNP declined from 7.13 percent in 1950, and 5.93 percent in 1959, to 4.39 percent in the second quarter in 1969; as a percentage of gross domestic investment, the decline was from 40.8 percent in 1954, and 39.4 percent in 1958, to 29.0 percent in the second quarter of 1969. During 1961-1968, measured in uniform dollars, the average annual growth rate in investment in commercial construction was only 4.9 percent, and in housing only <u>0.5 percent</u>, while it was 5.2 percent for GNP, and 9.9 percent for investment in producers' durable equipment. In contrast, and in line with balanced goals for the whole U.S. economy, the annual average rate of advance through 1977 in commercial structures should be 5.9 percent, and in residential structures 11.2 percent, compared with 5.3 percent in GNP, and 4.1 percent in producers' durable equipment.

<u>Disparities in Federal stimuli provided</u>

The vital areas needing the most help have been given the least, and, in the main, <u>vice versa</u>. In 1966, of the 43.1 billion dollar value of depreciation and depletion allowances, 45.7 ~~19.7~~ percent went to manufacturing, and only 5.8 percent to real estate. During the fiscal years 1954-1969, viewing more than 6.7 billion dollars of average annual net expenditures for Federal subsidy programs, 57.9 percent were going to agriculture, 10.5 percent to air transportation, and only 2.9 percent to housing.

The lowly financial position of real estate

Contrasted with the belief that real estate is "in clover", that industry is doing worse by various financial tests than any of seven other basic industries which I have analyzed. Viewing net income as percentage of net worth, the figure in 1965 for real estate was 3.5 percent, compared with 6.0 percent for finance and insurance, 10.3 percent for manufacturing, and 8.2 percent for all industries.

The toll of rising interest rates

The impact of rising interest rates has borne most severely upon housing and other aspects of real estate investment, because, in real estate, long-term debt comes to almost 50 percent of total assets, compared with 12.2 percent for all industries. Since 1952, rising interest rates alone have imposed an excess cost aggregatingmmore than 17 billion dollars in connection with mortgages on 1 to 4 family homes. The rising interest burden imposed upon housing and supportive non-residential commercial investment has exceeded many, many times the total benefits flowing to these sectors through all types of Federal tax concessions.

Under these conditions, it would seem to be an upside-down public policy, or fiscal policy, to make the public stimuli available to these sectors, including those in tax form, even less favorable than they are now, and increasingly discriminatory as against other sectors. This is true, not only in terms of economic and social considerations, but also in terms of the revenue problems of the Federal Government viewed more narrowly. Any recoupment of Federal revenues by further tightening up in these sectors would be a mere bagatelle, compared with the potentials for recoupment along beneficial rather than damaging lines when measured in terms of economic activity and human well-being.

Specific provisions of the Bill relating to housing and nonresidential commercial investment

There is not room, in this very abbreviated summary of my testimony, for me to deal fully with the specific provisions of the Bill which would have these deleterious effects. But briefly, the provisions which would be damaging to both housing and nonresidential construction investment include substitution, in the case of used buildings, of straight-line depreciation for the presently allowable 150 percent declining balance method (sec. 521); the recapture provisions (sec. 521); the treatment of "excess" depreciation under LTP and allocation of deductions (secs. 301, 302); the limitation on interest deductions (sec. 221); the "additional preference" Treasury proposal; and certain retroactive features of the Bill. Applicable to new nonresidential structures but not to housing, there is also the undesirable substitution of 150 percent declining balance method for the double declining balance method. These technicalities are dealt with in detail in my full testimony.

Summary related to housing and nonresidential commercial investment

If there were time, I respectfully submit that this Committee should be dealing with methods to accelerate housing and nonresidential commercial investment, instead of adding to its present plight. The least that should be done now is not to do the latter.

The difficulty with some of the so-called reform provisions of the Bill, relating to housing and nonresidential commercial investment, is that the baby is being thrown out with the bath. In the laudable desire to catch those who are "getting away with something", scores of thousands of worthy and essential enterprises will be hit who are not now getting away with anything, but instead serve the national interest. Indeed, while the Bill in its present form attempts to catch those who are getting away with too much in some industries, by delimiting some of the special tax incentives they have enjoyed, such as accelerated depreciation, it does not apply the same method to those in other industries who are generally or even to a greater degree getting away with something. The Bill makes this distinction on the ground that these are the industries requiring stimulation. But that is no justification for anyone getting away with something in such industries.

The appropriate method to catch those who are getting away with something is by limiting total allowable deductions, so as to permit none to pay too small a percentage of their incomes, or zero percentage, in taxes. The provisions of the Bill intended to do this should be further strengthened. But the enlargement or contraction of special tax incentives should relate to the condition of the industry affected, and its relationship to national needs. That has been forgotten thus far, in the treatment of housing and nonresidential commercial investment. I earnestly hope that this Committee will help to correct this dangerous imbalance.

TESTIMONY OF LEON H. KEYSERLING*
IN PART REPRESENTING REALTY COMMITTEE ON TAXATION
AND IN PART AS INDEPENDENT ECONOMIST
SENATE FINANCE COMMITTEE
FRIDAY, SEPTEMBER 26, 1969

* Former Chairman, Council of Economic Advisers. Consulting economist and attorney.

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CHARTS

*Refers to tax proposals and actions, 1963-1964

CHARTS (continued)

APPENDICES

TESTIMONY OF LEON H. KEYSERLING*
IN PART REPRESENTING REALTY COMMITTEE ON TAXATION
AND IN PART AS INDEPENDENT ECONOMIST
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FRIDAY, SEPTEMBER 26, 1969

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to appear before you, during your consideration of one of the most important tax measures, and in fact one of the most important economic measures, in many a year. Those in the Congress and elsewhere who have thus far toiled so diligently this year to make our Federal tax system more equitable, and to improve it as a fiscal weapon toward achieving and maintaining the maximum employment, production, and purchasing power objectives of the Employment Act of 1946, deserve the commendation of all thoughtful citizens. I have high hopes that changes in the Bill now before this Committee will bring about improvements in it which are still vitally needed.

General Considerations

I appear here today on behalf of the Realty Committee on Taxation (an Appendix to my testimony describes this Committee) with respect to those provisions in the Bill bearing upon housing and other aspects of real estate investment, although all of my analysis and conclusions have been arrived at independently, and I believe in the public interest. However, a major portion of my testimony deals with portions of the Bill other than those affecting real estate. This is in part because I believe this is essential to shed adequate light upon the portions dealing with housing and other aspects of real estate investment, and in part because I cannot refrain from this opportunity once again -- as many times in the past -- to bring my general

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economic and fiscal views before this Committee. This major portion of my testimony is offered, not on behalf of the Realty Committee on Taxation but rather in my independent capacity as an economist who has tried to devote a major portion of his time and efforts to problems of the American economy and the American people.

Some provisions of the Bill, even as it now stands, would greatly improve the equity of the tax structure, and help to close some unconscionable tax loopholes which have persisted for far too long. But viewed as a whole, the Bill, in my judgment does not go nearly far enough in the direction of improving the equity of the Federal tax structure. In addition, on net balance, the allocation of the various tax changes proposed, based as they are upon faulty economic diagnosis, would worsen rather than improve the economic equilibrium, and thus militate against restoration of maximum employment, production, and purchasing power. And in the name of reform, some of the proposals if enacted, especially those bearing upon housing and related commercial construction, are ill-designed and ill-timed, would further distort the treatment of our great national priorities, would conflict seriously with other programs and objectives to which the Federal Government on a long-range basis is committing billions of dollars, and would seriously increase unemployment and work against economic growth. The net relinquishment of Federal revenues which would result from the Bill as now drawn might not be too large if the composition of the proposals were drastically changed, but is much too large so long as these proposals retain their current composition. This is because some of the reductions and concessions are unwarranted both economically and socially, and should have substituted for them a larger prospective revenue take by the Federal Government and the allocation of these revenues to the services of our great domestic public priorities. In all of these connections, I shall say something about the problem of inflation.

We are far too prone to consider current tax proposals without an adequate review of the lessons of the past, and without setting these tax proposals in the controlling perspective of our overall economic and financial capabilities and needs, as well as our social objectives as a nation and a people. In order to help restore the balance on these scores, I shall refer, at various stages in my testimony, to my studies and findings in opposition to the massive tax cuts of 1964, and indeed to the whole series of changes in the Federal tax system during 1962-1965. At various times in the past, these studies and findings have been brought to the attention of this Committee, by my direct testimony and otherwise.

In brief, my line of argument has consistently been that these 1962-1965 tax cuts and concessions, and especially those in 1964, would undoubtedly stimulate the economy for a while after their enactment. But I pointed out insistently that, in the longer run, they would work against adequate economic growth, because the allocation of the cuts and concessions were so far out of line with the requirements for economic equilibrium at reasonably full resource use. I also forecast that these tax actions would increase the problem of inflation and the balance of payments, because they were founded upon incorrect diagnosis of both of these problems. I insisted that the distribution of these tax cuts and concessions were indefensible from the viewpoint of equity. Last but not least, I took the position that such huge amounts of tax cuts and concessions were at the expense of imperatively needed domestic priority-spending programs which, in words but not in action, had long been declared for by almost all responsible groups, including the Federal Government itself. Because in my judgment some of these errors are now being repeated in the current Bill as now drawn, and because they are highly relevant to the specialized subject of housing and other aspects of real estate investment, I feel justified in the review of developments to date, which I now shall undertake.

The Core Problem Of Inadequate Economic Growth

My Chart 1 shows that we have fallen far short of achieving the goal of sustained and optimum economic growth. From the enactment of the massive tax cuts in 1964 to the middle of 1965 or thereabouts, the rate of real economic growth was rewardingly high. But by then, definite signs of serious faltering were clear. But we were "saved" for a time by the vast and unexpected increase in defense spending due to the Vietnam war (by which I imply no evaluation of our international policies). However, even with these vast increases in defense spending, the real growth rate of the economy dropped to 2.5 percent from 1966 to 1967, and averaged annually only 3.7 percent during 1966-1968, compared with the 5.1 percent averaged annually during 1960-1966 with remarkably stable price levels. It is now estimated that the real rate of economic growth during 1969 may be only in the neighborhood of 3 percent, and might get even lower before it gets better. This is a dangerously poor performance, in view of our domestic and international obligations and burdens, and in view of the fact that maintenance of so low a growth rate for much longer will lead to serious increases in unemployment. Even today, unemployment, when fully measured, is far to high among vulnerable groups, and we should all know by now what this imports in terms of civil and social unrest and disorder, apart from being unacceptable on all other grounds.

Considering also that plants in general are now operating on the average at only about 84 percent of capacity, when they should be running well above 90 percent, the clamor about an "overheated" economy is a profound and costly error, in terms of the relationship between our human and other production capabilities and our actual production of goods and services. The term "overheated" is properly applicable to the excessive price inflation, but it is utter confusion -- for reasons which I shall demonstrate -- to mistake this rampant price inflation for an "overheated" or over-strained economy in a true sense. Entirely to the contrary, the rampant inflation is in large measure due to the very fact that the economy is not performing adequately in real terms.

My Chart 2 depicts the costs of deficient economic growth in the U.S. economy. I estimate that, during the period 1953-1968 as a whole, we forfeited more than 917 billion dollars of total national production (measured in 1970 dollars), and lost more than 38 million man-years of employment opportunity, in consequence of the deficient average annual economic growth rate. In 1968 alone, our economy was operating almost 82 billion dollars below total national production, and this was accompanied by more than two million man-years of excessive unemployment (based upon the true level of unemployment, including full-time unemployment, the full-time equivalent of part-time unemployment, and concealed unemployment in the form of nonparticipation in the civil labor force due to scarcity of job opportunity). And if the rate of real economic growth during 1969-1977 should average annual approximately the same as during 1953-1968, we would forfeit considerably more than a trillion dollars of total national production, and experience more than 31 million man-years of unemployment in excess of the minimum unemployment consistent with maximum employment. When we see and hear on all sides the evidence of a nation torn by the perilous conflict between those who insist that we "cannot afford" to keep our guard up in the world if we attempt to vindicate our great domestic priorities, and those who insist that we "cannot afford" to vindicate our great domestic priorities unless we let down our guard all over the world, I am amazed that economists and others have in so great degree lost sight of the potentials and implications of the great nonsecret weapon of America's productive power if fully called forth.

To indicate these potentials, my Chart 3 sets forth a balanced series of goals for the U.S. economy, projected from actual levels of 1968 to the years 1972 and 1977, and set forth at the fiscal 1969 price level as estimated at the time of the President's fiscal 1970 Budget submission. One aspect of this portrayal, which is especially relevant to the Bill now before this Committee, are the uniquely high rates of expansion set forth as needed for residential construction. Another aspect, extremely relevant to the current Bill in general, are those portions of the chart which indicate how much we can afford (without appreciable changes in tax rates at the Federal level, and without distorting traditional ratios between private and public endeavors) to enlarge the Federal, State and local levels those types of public spending which are the only means of vindicating the most urgent of our domesticpriorities -- if only we restore and maintain the maximum rate of real economic growth to which we are committed by the Employment Act of 1946, and even more importantly are committed to by the realities apparent everywhere on the current scene.

Economic Equilibrium And Tax Policy

To maintain the economic equilibrium required for optimum economic growth, we must examine the requirements for equilibrium, and also examine the high relevance of Federal tax policy to the maintenance of such equilibrium. In this connection, my Chart 4 sets forth a series of balance goals for the Federal Budget, geared to economic growth and priority needs. I will not dilate here upon the various programs set forth in this model Federal Budget, except to say that their realization would bring us close by 1977 to a land in which we no longer suffered from substantial poverty, slum living for one-sixth of our people, poisonous airs and waters and neglected natural resources, vast disparities in agriculture and rural life, ramshackle and understaffed public schools, and health services beyond the reach of scores of millions of our people at costs within their means. A distinctive feature of this chart is the indication that Federal outlays recommended for 1977 would be smaller in ratio to our national production than in 1969. Another feature of this projected 1977 Federal Budget is that, in absolute amounts, quite reasonable or even liberal allowances are made for national defense, space technology, and all internationals, without any sacrifice of the great domestic priorities. Looking at the composition of the tax changes proposed in the current bill as it now stands, I cannot believe that these proposals stem from an adequate analysis of our economic, financial, and social problems and potentials in full perspective.

Most seriously of all, I do not believe that the proposals in the current Bill in its present form are designed to stimulate and activate the full but not excessive rate of real economic growth which we need and can achieve. The long term departure from adequate economic growth, not only to an extraordinary extent during 1953-1960, but also to a lesser although serious extent during 1960-1969, has been occasioned fundamentally by a gross misallocation of economic activity and the incomes supporting and inducing such activity, from the viewpoint of economic equilibrium. Each period of real economic slow-down or stagnation or recession has been preceded by a relatively excessive expansion of the ability to produce as represented by private business investment, and especially private investment in plant and equipment, at the expense of relatively inadequate expansion of ultimate consumption in the form of private consumer spending and public spending at all levels, combined. My Chart 5 demonstrates this for the period 1961-1968. Measured in constant dollars, while total national production grew only 42.2 percent, private business investment in plant and equipment grew 65.5 percent. While wages and salaries grew only 44.5 percent and farm proprietors income only 3.6 percent, corporate profits grew 55.4 percent, personal dividend income grew 58.0 percent, and personal interest income grew 84.9 percent. During 1967-1968, a reaction set in, which almost brought to a halt the expansion of private investment in plant and equipment, due to obvious overcapacity; but even so, corporate profits grew 7.1 percent while wages and salaries grew only 5.6 percent and farm proprietors' net income only 1.4 percent. We all know that, during 1969 to date, private investment in plant and equipment is again proceeding at a fantastically high and dangerously nonsustainable rate relative to the rest of the economy, while progress in the real incomes of wage-earners and farmers and millions of other people of lower and moderate incomes has been virtually brought to a halt, or even set back in real terms, due in large part but not entirely to rampant price inflation.

Federal spending for some of our public domestic needs is being cut back drastically. Total Federal spending on the domestic scene is being held far below either our economic equilibrium or our social needs. And total Federal spending, in fact, is insufficient to close a reasonable portion of the gap between other types of spending and the spending requirements for maximum employment, production, and purchasing power and optimum economic growth.

Certainly, these disparate trends all along the line must be promptly and vigorously corrected, lest we instigate an even more deficient real economic performance than is currently in process, instead of moving in the directions we ought to go. All of these considerations, as I shall show, are directly related to the portions of the Bill bearing upon housing and other real estate investment.

Current Tax Bill, Investment And Consumption Allocations

Bearing these considerations in mind, I turn now to specific consideration of the current Bill, beginning with an analysis of its allocations between the investment function and the consumption function, which, as indicated above, I hold to be funadmental to all other considerations. First of all in this connection, I call the Committee's attention to my Chart 6, making manifest my early protest against the unsound nature of the allocations between the consumption function and the investment function, as embodied in the tax cuts and concessions during 1962-1965. In view of what has happened since, I hardly see how many responsible economists could now challenge the validity of the position I then took, although I had mighty few supporters at that time. Be that as it may, I feel that the proposals in the current Bill, while less egregiously so than earlier, run counter to the considerations of an appropriate and viable balance between investment and consumption.

This crucial subject is dealt with on my Chart 7. Excluding the proposed tax reforms, it indicates that, on net balance, the House Bill would increase the after-tax benefits to investment only nominally, while the Treasury proposals would increase the after-tax benefits to investment by 1.1 billion dollars, in both instances allowing for the effects of the repeal of the investment tax credit. Taking into account the entire train of events to date as I have discussed them above, and the allocation to the investment function in the neighborhood of 8.6 billion dollars by the tax actions of 1962-1965, I can find no justification whatsoever for the current proposals, excluding the proposed tax reforms. It seems to me highly inconsistent and ironic that, despite all of the furor about excessive investment and the need to restrain it by repealing the investment tax credit (which repeal I highly favor), the effect of without reformsof the House Bill is to cancel out a major part of the impact of the repeal of the investment tax credit by other concessions to saving for investment purposes, while the net effect of the Treasury proposal is to far more than counteract such repeal (for details, see third following paragraph).

I deem this analysis of the impact of the current proposals excluding the tax reforms to be more significant than the analysis including such reforms. The reforms are more controversial than the other sections of the proposed Bill, all experience indicates that there is much more doubt as to how the reforms will come out in the final legislation, and besides, some of the so-called reforms are highly undesirable for reasons which I will disclose as my testimony proceeds.

However, if the tax reforms are included, as shown on the lower portion of my Chart 7, the House Bill would result in a net after-tax tightening up on the investment function in the amount of 3.9 billion dollars, and the Treasury proposals would do this in the amount of 2.5 billion dollars. These provisions do not go far enough.

My own suggestion is as follows: the investment tax credit should be repealed. The additional tightening up on investment (related both to after-tax funds available directly for investment and after-tax/personal income saved for investment purposes) as embodied in the House Bill, including the reforms, should be enacted, subject to some modifications which I set forth below. Investment in many basic areas is far too ebullient. Profit margins in general are high enough and in many key instances far too high. And even from the viewpoint of investment and profits in the long-run, the best results will be obtained by more accent upon private and public consumption to restore the economic equilibrium, and thus to promote the higher rate of real economic growth, in which business shares very generously. It follows that, while I favor the small additional incentives to investment in the form of accelerated depreciation for ani-pollution efforts, etc., I favor neither the 2.0 billion dollar after-tax benefits to investment embodied in the House Bill (with or without the reforms), in the form of the estimated impact upon personal saving for investment of personal tax cuts less the impact upon individuals of the repeal of the investment tax credit, nor the 3.3 billion dollar after-tax benefits to investment embodied in the Treasury proposals (with or without the reforms), including also corporate tax relief. The about 6 billion dollar decrease in the after-tax allowance to investment which I favor could beneficially be utilized in the form of additional Government revenues distributed to the great priorities of our domestic needs, which are now being so seriously starved. Even this would be beneficial to investors in the long run by adding to economic growth, human justice, and social contentment. As I shall make abundantly clear as I proceed, while I favor this amount of net tightening up on investment, my comments are not applicable to housing and related real estate investment. Further desirable tightening up in other areas would yield this 6[illegible] billion dollar net without tightening up on housing and related real estate investment.

Equitable Considerations In The Tax Bill

I turn now to equitable consideration, as distinguished from the purely economic equilibrium considerations set forth above, although I must stress most emphatically that the whole problem of departures from economic equilibrium is at bottom a problem of serious income maldistribution. Improved income distribution would do more than anything else to help restore and maintain that balance between investment and consumption which is essential to optimum economic performance, and to the achievement of the enlarged public revenues (at any given tax rates) which flow from such optimum performance.

In this context, I turn first of all to my Chart 8, which indicates as of 1967 the annual money incomes before taxes of various income groups, as these groups relate to poverty, deprivation, comfort, and affluence. I will not linger upon this demonstration, except to state that it indicates dramatically the need to use Federal tax policy to improve income distribution. The chart also shows 1972 and 1977 goals for the reduction of poverty, within the model for balanced economic growth earlier set forth in this testimony. My Chart 9 shows even more vividly the terribly indefensible income distribution in the U.S. from 1947 to 1966, and further indicates a totally unacceptable amount of improvement over the years. In 1966, as to families, the top one-fifth income grouping received 41 percent of total income; the two top fifths received 65 percent of total income; the lowest fifth received only 5 percent; the lowest two-fifths only 17 percent; and the three fifths counting from the bottom received only 32 percent. As to unattached individuals, the situation was, in some respects, very much worse

To divert for a moment, this whole problem of income distribution and the need for vast improvement is intimately associated with housing conditions, home construction, urban renewal, and related aspects of other real estate investment. These activities not only increase incomes directly by adding to employment opportunity, but increase it indirectly by income-aids to many forms of housing, and by removing the oppressive housing conditions which impair morale, health, productivity, and incentives. In due course in my testimony, I will develop the truly dangerous extent to which a number of provisions in the current Bill, as now written, would devastatingly affect these lines of enterprise.

In view of rapid inflation and other developments, it may well be that the distribution picture in 1969 is even more shocking than it was in 1966.

Mindful of this core problem of income distribution, I have not only emphasized for many years the value of maintaining a highly and even increasingly progressive Federal tax structure, but also have called attention to how misleading it is -- though many who know better do so -- to look only at the Federal income tax structure, in appraising whether or not we have anything approximating an equitable tax structure in the U.S. In 1966, as shown on my Chart 10, scrutiny of the Federal income tax structure alone would indicate a moderately progressive tax system, although not nearly as progressive as I think it should be. But people do not only pay Federal income taxes. They also pay social security taxes; State and local income, sales, and gasoline taxes; and personal property and real estate taxes. Taking all of these types of taxes into account, those with incomes under $3,000. in 1966 paid 14.1 percent of their incomes in taxes of all kinds, contrasted with the 3.7 percent which they paid if one looked only at the Federal income structure. To be sure, these people and some others will pay no Federal income taxes if the proposals now before this Committee are enacted, and that is all to the good. But taking into account what has been happening to other types of taxes, many of these people will probably pay a higher percent of their income in total taxes after this Bill is enacted than in 1966.

Turning again to 1966, those with incomes of $3,000-3,999 paid 19.3 percent of their incomes in all forms of taxes, or more than those in the groups running from $4,000 up to $14,999, and almost as much as those running from $15,000 to $19,999. Those from $20,000 to $49,000 paid 24.2 percent of their incomes in all kinds of taxes, contrasted with 19.3 percent for those from $3,000 to $3,999, while if one looks at the Federal income tax alone the contrast would appear to be between 18.7 percent and 6.6 percent. Those with incomes at $50,000 and over paid 38.8 percent of their incomes in all forms of taxes, which in my view was not nearly enough when compared with some of the other groups, particularly in view of the unique opportunity which many within these groups have to avoid if not to evade taxes. Further, comparison between this 38.8 percent figure and the 33.6 percent figure which indicates the share of these peoples' incomes which they pay in Federal income taxes alone shows vividly how much less heavily other types of taxes serve (proportionately) to increase the tax payments of these people when compared with those down in the income structure.

These were the reasons why, prior to enactment of the massive tas reductions in 1964, I protested the distribution of the tax cuts on the grounds that they were grossly inequitable. I insert in the record, at this point, my Charts 11, 12, 13, and 14, shedding light upon what happened in 1964. It is true that these charts were developed in 1963, and are not exactly in accord with what actually happened in 1964. But they are close enough to tell the essential story. And it should be remembered that most of the reforms were sidetracked in 1964, so that the protrayals without the reforms are the really significant ones.

The current consideration of what is hailed as "the greatest tax reform bill on

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record" provides a challenging opportunity, not only to avoid repeating in full measure the errors of 1964, but to commence to redress vigorously the worsening of the tax structure then accomplished, by a really progressive treatment of any tax changes put into effect henceforth. But by this entirely fair test, the Bill in its current form is woefully deficient.

As my Chart 15 shows, looking at both the House and the Treasury proposals, and also looking at the Bill without the reforms and the Bill with the reforms, those with incomes under $3,000, aggregating 38.8 percent of all tax returns, would receive only 9.0-13.7 percent of the total tax cuts. Those with incomes of $3,000 to $5,000, aggregating 16.2 percent of total returns, would receive only 7.8 - 14.1 percent of the total tax cuts. Meanwhile, those with incomes of $20,000 to $50,000, coming to only 2.3 percent of total tax returns, would receive 10.6-16.1 percent of the total tax cuts. Those with incomes of $5,000 to $10,000, aggregating 33.9 percent of total tax returns, would receive only 22.1-30.7 percent of the total tax cuts. Those with incomes of $10,000 to $20,000, aggregating 16.4 percent of total tax returns, would receive 28.5-34.4 percent of the total tax cuts.

Without the reforms, those with incomes of $50,000 and over, coming to only 0.4 percent of the total tax returns, would receive 13.4 percent of the tax cuts under the House Bill, and 17.? percent under the Treasury proposals. And in many ways, the comparison shown on the chart without the tax reforms are more significant than those shown with the tax reforms. This is because the tax reforms are the most debatable and the most uncertain as to enactment; because we know from experience that, when the reforms are dropped or mutilated, there are unlikely to be corresponding adjustments with respect to the general tax rates; and because the tax reforms bear down so very differently upon different people in the same income groupings, depending upon the nature of their incomes. For example, under the

Treasury proposal, those in the $10,000 to $20,000 income group would get a much higher percentage of the total tax reductions with the reforms than without them, while the over-$50,000 income group would receive an immensely greater percentage without the reforms than with them.

I know that it will be argued, as it has been, that under a progressive tax system, it is "natural" that a larger percentage of the tax cuts (relative to numbers of taxpayers) should go to those higher in the income structure than those lower down. The first answer to this is that it is hardly true. It is perfectly feasible to realign the composition of the tax cuts in the current Bill to achieve the reverse. In the second place, even if it were true, this would merely cast doubt upon tax cutting as the desirable measure now to be used, in either economic or social terms. If under tax cutting, it were not feasible to direct a larger percentage share of the benefits of total action taken by the Government to those lower down in the income structure than the current Bill does in its present form, in that event devices other than tax cutting should be used toward these essential ends -- for example less tax cutting in the higher parts of the structure, and more Federal spending directed toward the needs of the poor and deprived.

Beyond all this, the really meaningful thing is not the percentage tax cut, but the percentage <u>increase in after-tax income</u>. As shown by my <u>Charts 13 and 14</u> already referred to, I indicated how bad the 1964 tax action was by this test. And as shown by my <u>Chart 16</u>, while it would appear by looking at the percentage cuts in their taxes which would be applied to various income groups that the proposals in the Bill are quite progressive, the true and very different picture is shown by looking at the percentage increases in after-tax income, which is what really counts.

Looking first at the House Bill as is shown on the lower half of <u>Chart 16</u>, with or without the reforms, the income groups under $5,000 would be treated relatively well, though not nearly well enough. But those in the $5,000 to $10,000 groups would be treated the same as those in the $20,000 to $30,000 groups, and less favorably than those in the $20,000 to $50,000 group. Those above $50,000 would be treated immensely more favorably than others if one excludes the reforms, and in some ways the exclusion of the reforms is very pertinent, if not most pertinent. For as I have said, nobody knows what is going to happen to the reforms; we have learned from experience that the general changes in the structure are not revised when reforms are dropped in the process of legislation; and beyond all this, there will be many in the over-$50,000 group who will not be affected by the reforms in a degree comparable to others in this same group.

Coming over to the Treasury proposal, as shown on Chart 17, those in the income group $20,000 to $50,000, in terms of percentage increase in after-tax income, would be treated much more favorably than those between $3,000 and $20,000, with or without reforms. Without the reforms, those at $50,000 and over would be treated immensely more favorably than all others.

My position on this entire issue is extremely simple. To make the tax structure more equitable, to serve better our economic equilibrium needs, and to commence to redress some of the gross regressiveness brought into being by the 1964 tax changes, I submit that this is not the time at all to reduce one iota the personal tax rates, before reforms, applicable to those with incomes of $50,000 and over. All things considered, I have considerable doubts as to whether such tax reductions, before reforms, should be extended to those with incomes over $20,000. The amounts saved by foregoing these types of tax reductions should be used toward increasing the tax reductions or concessions lower down in the structure, with emphasis upon progressivity. With respect to those over $50,000, the only group where the reforms as against the tax reductions without the reforms changed the picture much, I do not believe that any of the reforms enacted to apply to these groups should result in their getting any tax reductions without reference to the reforms. The need for reforms does not depend upon the general tax structure as applied to these groups, and those among them who are getting away with what the reforms are designed to avert should not thereby be entitled to reductions in their general tax rates.

Everything else being equal, tax reduction of all kinds is fine for everybody. But everything else is not equal. What I am urging in essence is that, on all valid grounds, we should use any changes to be made in the personal income tax structure, whether considered with or without the effective reforms, to begin to redress the gross maldistribution of income after taxes which is now so unfair to our people and injurious to the economy. This in itself would be the greatest reform of all, and a Bill which does not really do this anywhere near adequately is using the glamorous word "reform" to mask the real results which would flow from its enactment.

In addition, I believe that the minimum tax provisions in the Bill should be very considerably strengthened. Among other advantages of doing this, it would reduce the real or alleged need for some of the so-called reforms, with which I shall deal in detail when I come to those provisions in the Bill which treat housing and related aspects of real estate investment.

I think also that there should be a more effective closing of the loopholes related to capital gains, as I have long held the view that it is wrong on all grounds that unearned speculative income should be treated more favorably than earned income. But, as I later discuss, housing and other real estate investment should not in this connection be singled out for discriminatory treatment.

I also feel that the maximum tax provisions should be eliminated or very substantially modified, for reasons going to the general issue of restoring a sifficient degree of progressivity in the Federal tax structure.

On revenue and other grounds, these changes would leave much more/room for re- construction of the so-called reforms bearing upon housing and related aspects of real estate investment, although this reconstruction is essential in any event.

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Another net consequence of my proposals in their entirety is that they would result in somewhat less net forgoing of Federal revenues than the Bill in its present form, even assuming that tax relief for those in the low and lower-middle-income brackets were carried, as they should be, further than the Bill proposes in its current form.

On the score of general fiscal considerations, I am not interested in improving the revenue position of the Federal Government per se as, for reasons fully stated above, I believe that the economy needs net stimulation, not net restraint. But things being what they are and views being what they are, I feel that the improvements in the Federal revenue picture which would result from my proposals in their entirety would leave more room for more realistic consideration of the so-called reforms bearing upon housing and other aspects of real estate investment, which I shall treat very fully later on in my testimony.

The Problem Of Inflation

The problem of rampant inflation is now at the center of the stage of national attention. It certainly deserves consideration in connection with fiscal policy. In view of the import of my entire testimony, to the effect that we should seek at once to accelerate the rate of real economic growth, I deem it essential to attempt to set the problem of inflation in a more analytic and realistic perspective than I think is represented by recent and current/efforts to deal with inflation. The materials which I bring before this Committee in this phase of my analysis have been called to its attention by me a number of times in recent years. Only because

highly unsuccessful

the issue is so important do I deem it appropriate to say, in passing, that actual economic developments to date have verified to a remarkable degree those conclusions which I commenced to set forth many years ago, and which were viewed with very widespread skepticism when first I set them forth.

Essentially, and contrary to the more common view, I hold that the inflation in the U.S. since the end of the Korean war has been augmented by a deficient rate of real economic growth, rather than sparked by an "overheated" economy. I feel that the effort, through tight money and rising interest rates, to fight inflation has repressed most undesirably the real rate of economic growth, even while it has added greatly to the inflation itself. I feel further that this policy of tight money and rising interest rates has distorted the economic equilibrium, by allocating too much income and incentives to the wrong lines of economic endeavor, and subtracting too much income and incentives from those lines of economic endeavor which require large acceleration, in the interest both of economic equilibrium and our great national priorities. The tight money and rising interest rates have also contributed mightily to the maldistribution of income. As I have frequently commented, they have fed the fat and starved the lean.

There is no better example of this than the housing industry and related aspects of other real estate investment. Here I am not, and for a long time have not been, in a minority: practically all informed persons have recognized the monstrosity of tight money and rising interest rates as applied to these economic sectors. But they have argued that the policy is necessary, nonetheless, to fight inflation by repressing economic growth. That argument also enters into the provisions of the current Bill pointed toward these sectors.

I will not here go into all of my reasons why tight money and rising interest rates are highly inflationary *per se*, but only set them forth very briefly. An increase in the price of steel is more inflationary than an increase in the price of bananas, because steel enters into more products. Money and the cost of money enters into more products than anything else, and thus increases in the cost of money will pyramid into rising costs and prices, including a large portion of those increases in wage demands which are related to that part of the increased cost of living due to rising interest rates all along the line. Tight money and rising interest rates, by repressing the rate of real economic growth and leading to excessive idleness in plant and manpower, reduced seriously the rate of productivity gains. This in itself is inflationary for many reasons, including the reason that it changes adversely the ratio between the trends in labor costs and the trends in money-wage gains.

Instead of elaborating further on a theoretical basis, as to why the repression in the economy which results from tight money and rising interest rates is inflationary per se, I now call attention to my Chart 18, which is empirical in that it looks at what has actually been happening, instead of indulging in classical theories which do not square with modern realities.

During 1952-1955, as shown on this Chart 18, the average annual rate of consumer price inflation was only 0.3 percent, when the average annual rate of real economic growth was 3.5 percent, and unemployment as officially counted averaged 4 percent. During 1955-1958, the average annual increase in consumer prices was 2.6 percent, although the average annual rate of real economic growth was only 0.8 percent, and unemployment averaged 4.9 percent. During 1956-1958, the average annual increase in consumer prices was 3.1 percent, while the average annual rate of real economic growth was only 0.2 percent, and unemployment average 5.1 percent. During 1958-1960, the average annual rate of consumer price inflation fell back to 1.2 percent, while the average annual rate of real economic growth was 4.3 percent, and unemployment averaged 6 percent. During 1960-1968. the average annual rate of real economic growth rose to 4.8 percent, and the average annual increase in consumer prices was only 2 percent. Unemployment average 4.9 percent, but was reduced greatly to 2.6 percent by 1968. During 1960-1966, the average annual increase in consumer prices was only 1.6 percent, while the real rate of economic growth averaged 5.1 percent. Unemployment averaged 5.3 percent, but was reduced to 3.8 percent by 1966. During 1966-1968, the average annual rate of increase in consumer prices was 3.7 percent, although the average annual rate of real economic growth fell to 3.5 percent. Unemployment averaged 3.7 percent, or almost the same as the 1966 level. The trends in wholesale prices and industrial prices are shown on the same chart, but I do not analyze them in detail because they tell basically the same story.

Certainly, these trends in the main indicate an inverse or negative rather than a positive correlation between the rate of real economic growth and the rate of price inflation. Nor do they indicate in the main that a movement toward reduction in unemployment promotes an increase in price inflation.

But it may be argued that, while a higher rate of real economic growth or a lower level of unemployment does not in itself promote inflationary tendencies, inflation is nonetheless promoted by an economy <u>moving toward reasonably full or optimum resource use</u>. However, this thesis is also discredited by the trends depicted above. For example, during 1956-1958, with unemployment averaging 5.1 percent, and with the sharpest recession since 1952 occurring within that period, the average annual rate of consumer price inflation of 3.1 percent was about twice as fast as the 1.6 percent average during 1960-1966 when unemployment averaged 5.3 percent, or about the same. From 1966 to 1967, the price inflation was 2.8 percent, and unemployment stood at 3.8 percent.

The analysis could be further complicated, and my conclusions might be somewhat modified, by the introduction of time-lag factors and some others. But I submit that my analysis and conclusions are in the main sustainable, and most assuredly do not justify the unalloyed policies which are at times deliberately sought to generate excessive deviations from optimum real economic growth, and at least to tolerate excessive unemployment, in the pursuit of a nonsustainable proposition bearing upon the relationship between price trends and these other factors.

My own explanation of inflationary trends -- which I commenced to set forth in the mid-1950's before future experience lent much further support to my position -- runs as follows: In an economy characterized so largely by administered prices, an inadequate volume of real economic activity and insufficient employment, or even the clear prospect of these, tends to generate protective efforts to compensate for these deficiences through the managerial price-making process. This thesis is perhaps most clearly borne out by the resumption of a relatively high rate of price inflation from early 1966 forward, when the signs became large and umistakable that the economy was entering a period of severely reduced real economic growth, and when recession talk was in the air.

In some other areas, such as medical care and housing, and at times in the area of farm prices, rising costs or prices have been due to entirely different factors. In the medical field, there have been shortages of facilities and personnel relative to the real need, engendered by long neglect of adequate public spending for these purposes, such neglect being fomented by the avowed desire to fight inflation. In the area of housing, rising costs have not been due to excessive aggregate demand for housing relative to the Nation's needs, but instead have been due in large measure to the fantastically rising interest rates, again allegedly designed to fight inflation. Rising costs to occupants have also been due to the housing shortage.

The thesis that excessive aggregate demand (which in fact we have not had any time in recent years, when measured against the demand required to sustain optimum economic growth and bring unemployment low enough) explains the inflations during recent years, and particularly during 1967-1968, breaks down at all points. It is further corroded by the special industry studies which I have made from 1952 forward, indicating even more clearly the propensity to increase prices more rapidly during periods of relatively high unused capacity and relatively high unemployment than during periods of relatively less unused capacity and relatively less unemployment.

Frequently it is argued that the inflation has been of the cost-push variety, occasioned by wage costs per man-hour rising faster than productivity. But this position is completely torpedoed by the empirical evidence.

During 1960-1968, in the total private nonfarm economy, measured appropriately in constant dollars, productivity rose at an average annual rate of 3.1 percent, while hourly wages and salaries rose at an average annual rate of 2.9 percent. It is even more revealing to break this period into two parts. During 1960-1966, productivity rose at an average annual rate of 3.4 percent, while wages and salaries rose at an average annual rate of only 2.7 percent. This was a period when the average annual rate of real economic growth was 5.1 percent. But during 1966-1968, when the average annual rate of real economic growth declined to 3.7 percent, productivity rose at an average annual rate of only 2.2 percent, and wages and salaries at an average annual rate of 3.2 percent.

The trends in manufacturing tell the same story, only more so. During 1960-1968, the figures were 3.2 percent for productivity, and 2.2 percent for wages and salaries. During 1960-1966, the figures were 3.7 percent for productivity, and 1.9 percent for wages and salaries. During 1966-1968, the figures were 1.7 percent for productivity, and 2.9 percent for wages and salaries.

This leads to the implication that the relative trends during 1966-1968 exerted cost-push inflation, and thus explained the rapidly accelerating inflationary trends.

I cannot accept the position that the relative trends in wages and salaries and productivity during 1966-1968 justified in any sense the accelerated price inflation during this period, particularly in view of profit margins and aggregate profits. Consumption, supported so substantially by wages, had certainly not been excessive, but rather has been deficient, during the past 2 years, by economic equilibrium tests.

But let us assume for the moment -- contrary to my own view -- that the relative trends in wages and salaries and productivity during 1966-1968 "caused" or even "justified" the accelerated price inflation. In that event, this happened, not because the rate of advance in real wages and salaries was too high in terms of any equilibrium model for reasonably full use of our potentials, but rather because the rate of productivity growth dropped abysmally. And this happened precisely because of the abysmal decline in the real rate of economic growth coupled with the election (desirable in itself) to translate this into less efficient utilization of the employed labor force rather than into more overt unemployment. Of course, such inefficient utilization is a form of concealed unemployment.

Under these circumstances, how wrong and upsidedown it is to try to stop this kind of cost-push inflation by further repressive measures, designed to reduce still further a seriously inadequate rate of real economic growth.

Further, my basic position is that policies designed effectively to achieve a stable and optimum economic growth would in the long run yield less net price inflation than result from erratic ups and downs in the real economy, rapidly changing labor and business expectations, and general uncertainty. The evidence to date on this seems fairly clear. But even if the evidence were less conclusive or more arguable on rational grounds, we should choose the certain benefits of steady and optimum economic growth and minimal unemployment, instead of committing ourselves to a theory as to the cause of inflation which cannot be squared with what has been happening.

The entirely erroneous proposition that tight money and rising interest rates serve admirably to help contain inflation is essentially allied with the erroneous idea (discussed above) that policies inimical to optimum economic growth and conducive to excessive unemployment help to contain inflation. Consequently, the analysis which I present immediately below is essentially similar in method to that which I used in discussing the inflationary problem generally.

As shown by my Chart 19, during the period 1955-1968 viewed as a whole, the average annual growth in the nonfederally held money supply was only 2.5 percent, and the average annual real growth rate in total national production was at the deficient rate of 3.8 percent. I believe that there was a strong relationship between the deficient growth in the money supply and the inadequate economic performance, but I will not elaborate upon this particular point, especially because I believe that too much weight has been attached to monetary policy in the aggregate in this particular connection. Theoretically, and perhaps practically also, a more or less rapid growth in the money supply might affect the level of prices considerably, but should not affect the real trends in production and employment if economic equilibrium were maintained in the fundamental allocation of resource and in income distribution, which can be achieved either at a more or less rapid growth in the nonfederally held money supply.

Nonetheless, what I have just said does not apply to extreme cases. It seems perfectly clear that the extremely low growth rate in the money supply during 1955-1957, and again during 1958-1960, was intimately associated with the recession of 1957-1958 and the minirecession in late 1960 and early 1961. It also seems abundantly clear that the extraordinarily low growth rate in the money supply during 1955-

1966 was an important factor in initiating the extremely low real economic growth rate during 1956-1967 and the unsatisfactory average annual rate during 1966-1968. The relatively more rapid rate of growth in the money supply during 1957-1958 and during 1960-1961, and again during 1962-1965, appears to have been conducive to more favorable trends in the real rate of economic growth. The rapid expansion of the money supply during 1966-1968 seems clearly to have helped prevent the very serious deterioration rate of economic growth during 1966-1967 from being continued over a longer period of time. On net balance, in a long-term perspective, it seems quite clear that the monetary policy has been much too tight, and that a relatively liberal monetary policy is highly conducive to satisfactory economic growth.

More seriously, the monetary policy has worked powerfully against economic equilibrium, because it has helped to reallocate resources in directions bearing no relationship to economic equilibrium, and in many cases quite destructive of it. The tightening of the money supply has had practically no effect upon the relatively excessive investment booms in plant and equipment, because those indulging in these booms are not greatly affected either by general shortages of credit or by rising interest costs; they finance mainly out of retained earnings and out of the price structure. On the other hand, a better rate of economic expansion in other important sectors, or, more generally, a relatively larger ultimate demand composed of both private consumption and public demand, would have been much more conducive to economic equilibrium at steady and optimum growth, and these developments have been very harshly impeded by both right money and rising interest rates.

Most important of all, in the context of the argument that tight money and rising interest rates restrain inflation, let us look at the empirical evidence. The extraordinarily contraction in the growt' rate of the money supply during 1955-1957, while it impacted severely upon the real rate of economic growth, was accompanied by a 3.5 percent average annual rise in consumer prices from 1956 to 1957. The greatly expanded growth rate in the money supply during 1957-1958 was accompanied by a reduction in the rate of consumer price inflation to 2.8 percent. During 1958-1961, there was throughout an inverse or negative correlation between the trends in the money supply and the rate of consumer price inflation. During 1962-1965, a sustained and relatively rapid expansion of the money supply was accompanied by remarkable price stability. During 1955-1966, a very sharp contraction in the rate of growth of the money supply was accompanied by a very rapid acceleration of the rate of price inflation. During 1966-1967, the money supply expanded about three times as fast as during 1966-1967, but the rate of consumer price inflation was slightly lower. During 1967-1968, the rate of expansion of the money supply was the same as during 1966-1967, but the rate of consumer price inflation was tremendously higher.

Viewing these relative trends in an adequate time perspective, it appears to be clear that excessive restraints upon the growth of the money supply worked toward more price inflation in the long-run for practically the same reasons that excessiv restraints upon real economic growth and employment expansion worked in the long run toward more net price inflation.

Beyond all this, the almost unbelievably erratic changes in the rate of growth of the money supply over the years represents an attempt at "fine tuning" which is utterly impractical, and really indicative of a wayward and thoughtless long-range monetary policy, and general economic policy as well.

Relevance of foregoing discussion to housing and other real estate investment

The foregoing discussion of the problem of inflation is critically relevant, as I have suggested above, to those portions of the pending Bill which deal with housing and related aspects of real estate investment. If the purpose of the Bill (or in any event, its consequences, as I shall show) is to curb certain aspects of housing and related real estate investment in the desire to curb inflation, the remedy is horribly out of line with the purpose, for reasons I have already stated. Shortages in housing and in related or supportive real estate investment manifestly exert a strongly inflationary impact upon the costs borne by those who live in houses, whether they buy or rent. The excessive idleness of plant and manpower today, and the larger excesses which I believe are inevitable in future unless the rate of real economic growth is accelerated, are inflationary for reasons which I have already stated. The corrosive effects of inadequate housing upon human beings and their productivity is inflationary.

But even if we needed to restrain the overall rate of economic growth in order to impede inflation -- which I do not believe for reasons already stated -- that would be no reason for distorting the economic equilibrium further, neglecting all human social considerations, and directing repressive efforts against the rescue and renewal of our urban areas which depend fundamentally, and by common consent, upon enormous acceleration of housing and related or supportive aspects of real estate investment. If we did in fact need to repress, beyond the effects of current measures, the current overall levels of economic activity, we should by all means cut back even further on some lines of expendable or excessive activity than the current Bill proposes to do. We should correspondingly redirect vastly more of our economic activity toward the great priorities which I have just mentioned. This further fortifies my arguments set forth above, in favor of changes in many provisions of the current Bill. It illustrates the inseparable relationship between these provisions and the housing and real estate provisions, and thus justifies my extensive treatment of these other provisions. I now turn to specific analysis of those provisions of the Bill which bear upon housing and related aspects of real estate investment.

The Role Of Housing And Commercial Construction In The National Economy
General comments on relevant portions of the current Bill

There is no proposition more generally accepted than the proposition that, even in terms of human and social interests alone, our top domestic problem is the rescue and restoration of our urban areas. Toward this end, the Congress, even as of now, has legislated the objective of -- although it has not appropriated the funds for -- many billions of dollars on an annual basis, looking a decade or so ahead. Broadly speaking, these efforts are directed toward sustaining an annual volume of home construction in the neighborhood of considerably more than twice the current level.

In recognition of this, there is a general belief that the current Bill as now written does not include housing in the repressive or restrictive changes in the tax laws relating to other aspects of real estate investment. This is incorrect. As I shall show in detail, various provisions of the Bill would be extremely hurtful to housing itself. They would thus run directly counter to the well-night universal view as to the nature of housing needs, and even counter to some of the most important programs of the Congress and the Executive Branch.

Even if what I have just said about the provision of the Bill with respect to housing were incorrect -- and they are correct -- an attempt to classify various types of housing,maintaining current tax benefits for some types but withdrawing it for others, or maintaining these benefits for new construction but withdrawing it from housing after transfer, is utterly unrealistic. The entire housing market and supply (with perhaps some exceptions at the top of the luxury market) is a seamless web. Construction of almost any type of housing adds to the supply and reduces the shortages. Construction of any type of housing helps to meet the great problem of housing's contribution to needed economic growth and employment in future. Construction of housing for middle-income groups exerts some upward

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shifting of housing use, and thereby reduces the pressures upon occupancy of unsatisfactory housing, as well as ameliorating somewhat the need for the construction of low-cost, low-rent housing, which involves the largest public costs.

In addition, it is most unrealistic and damaging to draw a sharp dividing line between housing and other forms of commercial construction or investment in real estate, leading to greatly differential treatment of the two, as the Bill in its present form does. Cities are not made up of houses alone. Urban deterioration is not limited to housing. Community facilities, stores, quarters for the occupancy of those rendering professional services, and even some aspects of industrial construction in urban areas, are intimately connected with the solution of the housing problem. They are intimately connected with employment opportunity. Many of these facilities and services are incorporated in the same structures as the housing units.

Moreover, if we are to develop the large-scale ventures which are essential to successful urban renewal, we need increasingly, and on an enormous scale, to promote the entry of large-scale enterprisers who combine housing ventures with the other types of ventures which I have mentioned. It would thus be giving with one hand and destroying with the other hand, if tax legislation were enacted which left the housing aspects of current tax legislation where it now is (which the current Bill does not even do), but draws in the reins sharply on these other types of ventures.

Similarly, there is little or no merit in the argument that, if real estate investment other than housing is further curbed, there will be more investment funds available for housing, and especially low-cost low-rent housing. In the first place, as I have already indicated, the funds now going into these other aspects of real estate investment are too small, not too large, and this even works against adequate housing development and urban renewal. In the second place, even if funds were turned away from these nonhousing forms of investment, they would not go in large measure into housing, and certainly not into low-rent low-cost housing, the stimulation of which is advanced as main reason for turning funds away from these other forms of investment. Practically all of the funds going into low-rent low-cost housing are underwritten almost completely in one form or another by the Government, in small part by direct subsidies, and predominantly by effective guarantees of the private capital flowing into such undertakings. It is therefore chasing a whil-o'-the-wisp to hope that the further curbing of these other forms of investment would be of measurable significance for low-rent low-cost housing. To any extent that it might be feasible to transfer investment funds now going into other purposes into housing in general, or especially into low-rent low-cost housing, the sensible approach, as I have proposed earlier in my testimony, is to make the curbs on those types of investment which are now expendible or excessive even more stringent than they are in the Bill as now drawn. I predict that, if the Bill is enacted in its present form, a large portion of the funds now flowing into real estate investment other than housing will (a) flow into forms of investment of far lower priority than either of these two types, or (b) stagnate, thus contributing to more idle manpower and other productive resources.

To indicate the magnitudes at stake, I have estimated in a number of studies, some of which have previously come to the attention of this Committee, that close to half of the total employment problem which will be generated by technological displacement in some industries, and by population growth, during the decade ahead can be solved within the ambit of adequate programs of urban renewal, focusing sharply to be sure upon housing, but necessarily including these other types of related or supportive ventures. Aspects of the basis of these conclusions are indicated on my

Charts 3, 4, 22, and 23, already discussed.

I am as fully aware as others that some of those who have engaged in real estate investment have taken indefensible advantage of the existing tax laws, to the effect that their tax payments have been excessively reduced, or even reduced to zero. I desire, as much as anybody else, to remedy these evils, and commend the purpose of the House and of this Committee to do just that. But in sober realism, we must now throw out the baby with the bath. All aspects of national tax policy must look at the whole picture, and must recognize that any specialized or ad hoc tax policy which is "liberal" enough to accomplish its basic purpose will allow enough room to permit a small percentage of those in the relevant line of endeavor to get away with excesses. Indeed, even tightening up of tax policy along the lines set forth in the current Bill would probably still leave room for some of the powerful, skillful, and well-advised to get away with more than they should, even while these provisions would cripple or destroy hundreds of thousands of essential and useful enterprisers in housing and related aspects of real estate development who are not getting away with anything.

This does not mean that I do not favor appropriate measures directed against those who are getting away with more than they should. I certainly do. The most constructive and useful measure in this direction is the vigorous limitation on tax deductions (LTD), which, as I have indicated above, should be strengthened well beyond the Bill in its current form.

The critically deficient rate of activity in housing and related real estate investment

I now turn to more specific factual illustrations bearing upon what is happening to housing and related aspects of commercial construction. First of all, my Chart 20 calls the attention of this Committee to the alarming decline in housing starts during 1969. The annual rate, seasonally adjusted, has declined month by month from 1,845 thousand units in January to 1,314 thousand units in June, a staggering decline of about 28.8 percent. This drop is continuing, and the end is not yet. Under these circumstances, I cannot understand why proposed legislation should now take the risk, even if it did not import the certainty, of augmenting this alarming downward movement by removing existing tax incentives. These incentives, in the view of all knowledgeable people, have certainly been stimulative on net balance, even if the stimulation has involved some improper costs as against enormously larger net advantages. Even those not certain that the proposed changes in the Bill would be as damaging as I and other knowledgeable people appraise them to be, it seems to me entirely unwise to introduce into the housing picture any elements of uncertainty at this time, or in the near future.

If we should take this unfortunate course how could we come within hailing distance of more than two million housing starts per year, redress the current conditions and trends within our urban areas, remove the slums within which live at least one-sixth of our people, or alleviate the excessive housing costs being borne by so many other millions of our people, due in large measure though not entirely to the inadequate growth in the housing supply?

My Chart 21 serves two purposes. It depicts on a long-range basis the role of housing and commercial construction combined in the national economy, and also depicts the ominous relative decline since 1955. In 1955, these two elements of investment (investment in housing and investment in commercial construction) came to 6.41 percent of GNP. Even this was lower than the 7.13 percent reached in 1950. But by 1968, with declines in most years since 1955, the ratio was only 4.35 percent. It was only 4.39 percent in the second quarter of 1969.

Measured as a percentage of total private domestic investment, the ratio of investment in housing and commercial construction to the total was 40.8 percent in 1954, and 39.4 percent in 1958. In 1968, it was only 29.8 percent, and decreased further to 29.0 percent in the second quarter of 1969.

My Chart 22 approaches the same problem from another perspective. It shows that, during 1961-1968, measured in 1967 dollars, the average annual rate of growth in our Gross National Product was 5.2 percent; in personal consumption expenditures, 4.9 percent; in private domestic investment, 6.2 percent; and in Government purchase of goods and services, 6.0 percent. Again broadly speaking, I think that this represented a reasonably good balance in the long-run, except that the private domestic investment sector did not include nearly enough housing and related real estate investment. Instead, it included far too much investment, relatively speaking, in producers' durable equipment and new plant and equipment. (These separate categories overlap considerably, but are not identical). The average annual rate of growth in producers' durable equipment was 9.9 percent; in new plant and equipment expenditures, 7.5 percent; in commercial structures 4.9 percent; and in nonfarm residential structures only 0.5 percent. The relatively excessive rates of advance in the first two categories was due to excesses during subperiods of very strong and advancing prosperity. This contributed greatly to inflationary pressures, and then to severe cut-backs from time to time which impacted adversely upon the overall economy. These excesses were very substantially due to excessive tax cuts and concessions for these two categories, and also to excessive price-profits trends in many key industries. In vivid contrast, the growth rate in commercial structures relative to need lagged, and the growth rate in nonfarm residential structures was lamentably low. This does much to explain one of our top domestic problems, urban deterioration. Our cities are becoming obsolescent because they are not being renewed, and these two types of activity are at the heart of such renewal.

By this pragmatic test, it appears clear that the housing and related categories, so inseparably connected with urban life, have had incentives which have been deficient rather than excessive. I am not overly impressed with theoretical or mathematical displays that some tax concessions or other benefits are either too large or too small, or with spectacular showings that somebody may be "getting away" with something (although this should be appropriately remedied), or with tenuous attempts to delineate causes and effects with precision. It remains an irrefutable datum that we have been moving dangerously too slowly in the residential and construction areas which I have identified. And because adverse changes in the rules of the game always produce unsettling effects which cannot be exactly measured -- not only economic and financial, but also psychological -- I reach the conclusion that it would be unwise now to tamper adversely with the tax treatment of these two vital sectors. The Congress recently approved, during a Democratic Administration, a tremendous long-range housing and urban renewal program, at great cost to the Government. It appears that this program has also been approved by the current Republican Administration, or at the very least by the HUD Administrator. Why, then, should we retard with one hand what we are attempting to stimulate with the other?

The immense needs of the future

These conclusions are reinforced by looking to the future. My Chart 23 depicts balanced growth rate goals for important sectors of the economy. Aside from matters of detail, these goals are consistent with those put forward by many other private and public research organizations, and are explicit in the approved programs of the Government itself. Projected from 1967 to 1977, the indicated goals are an average annual rate of growth of 5.3 percent in GNP, and fairly similar rates of growth for the main components thereof. Considerably lower GNP goals would not appreciably affect the relationships, which are the real significance of the exercise. Compatible with these major-component projections, the average annual rate of growth projected is 6.5 percent for total fixed investment; 4.1 percent for producers' durable equipment, 5.9 percent for commercial structures; and 11.2 percent for residential structures. The higher-than-GNP rate of growth for commercial structures, and the extraordinarily high rate of growth for residential structures, are designed to compensate for the lag in these two areas during the past years under review, to make the relative growth rates in these two sectors compatible and mutually reinforcing, and to fulfill objectives for urban renewal almost universally shared. They are, for example, entirely consistent with recent housing and urban renewal legislation, and in fact are derived largely therefrom.

It must be perfectly clear, combining pragmatic examination of these goals for the future with a pragmatic examination of the record during the past eight years, that we now cannot afford to inject into urban renewal any factors which would be repressive rather than stimulative, and induce uncertainty instead of legitimate confidence.

Relevant aspects of the Federal revenues and expenditure picture

Let us now turn to the Government revenue and expenditure side of the problem. My Chart 24 shows the value of depreciation and depletion, in dollar terms, as expressed in corporate income tax rates. In 1966 -- and the choice of any other year would yield practically the same results -- the total value of depreciation and depletion allowances so expressed was 43.1 billion dollars. Of this value, 45.7 percent related to manufacturing; 22.5 percent to transportation, communication, and electrical, gas, and sanitary services; 7.9 percent to wholesale trade; 7.2 percent to the service industries; and only 5.8 percent or 2.5 billion dollars to real estate. Taking into account also that these data relate to all depreciation and depletion, and not merely to that portion affected by special concessions or allowances, it must be manifest that the absolute and relative size of any recoupments the Government might attempt through tampering with depreciation allowances in the case of real estate might be making a mountain out of a mole hill. In any event, it would yield very little additional revenues, relative to the positive arguments which I have set forth against taking this risk.

It is also revealing to look at the picture with respect to the dollar value of Federal subsidy programs, as distinguished from tax concessions in one form or another. My Chart 25 does this. For the fiscal years 1964-1969 inclusive, the average annual cost of the specified key subsidy programs of the Federal Government came to 6.7 billion dollars. Of these, 57.7 percent went to agriculture; 12.7 percent to health, education, welfare, and labor; 10.5 percent to air transportation; 8.9 percent to maritime; 7.3 percent to nonspecified categories; and only 2.9 percent to housing. In the fiscal year 1969, with the total subsidy figure estimated at 8.2 billion dollars, only 6.8 percent went to housing. Even in this year, the allocation to housing was strikingly small. And yet, its elevation from the five-year average of 2.9 percent to 6.8 percent demonstrates in itself the great effort being made to move forward more rapidly in this critical area. It thus negates the advisability of taking one step forward and another step backward by any distinctly adverse action in this sector.

The role of housing and related real estate in total fixed investment

My Chart 26 is designed to portray the immense importance of investment in residential and commercial structures, relative to total fixed investment. This facilitates contrast between these magnitudes and the tiny share of tax and subsidy benefits received by the housing and real estate categories, as already portrayed. In 1961, residential and commercial structures preempted 41.9 percent of total fixed investment. By 1968, this had dropped to 31.1 percent, another dramatic illustration of a gravely deteriorating situation. The goals for 1977, to which I have already referred in another connection, contemplate that residential and commercial structures should preempt an estimated 41.0 percent of total fixed investment, coming up close to the 1961 ratio, but running very far above the critically depressed 1968 ratio. Looking at these ratios in conjunction with my earlier data reveals (1) how disparately little Federal help these types of activities have been receiving, by way of tax and subsidy assistance, relative to their magnitude and vital importance, and (2) the basic goals set are incompatible with adverse treatment of housing and real estate at this time.

The lowly financial rewards to real estate

My Chart 27 should dispose of any erroneous notion that the real estate industry is "in clover", and should help to dispel the idea that the broken desire to take action against the relatively few who have been getting away with tax-avoidance excesses should be translated into new tax action which would hurt and penalize the industry as a whole, as it labors already under the tremendous burden of rising interest costs and other disadvantages which I have already depicted, and finds itself unable to rise to the challenge of vitally needed expansion of activity. In 1965 (latest year available) net income per the Internal Revenue Code, measured as a percentage of net worth, was only 3.5 percent for real estate, the lowest of the eight specific categories shown on the chart. It was 8.2 percent for all industry. It was 4.4 percent even in agriculture, 6.0 percent in finance and insurance, 8.2 percent in trade, and 10.3 percent in manufacturing. Net income as stated on books of account, as a percentage of net worth, was 4.9 percent in the case of real estate, again the lowest among the eight categories. It was 10.0 percent for all industry, 8.3 percent in finance and insurance, 9.6 percent in trade, and 11.7 percent in manufacturing.

Another vital factor shown on the chart is the ratio of long-term debt to total assets. This indicates the almost unique extent to which real estate has been affected adversely by tight money and rising interest rates. This ratio was

48.4 percent in real estate, contrasted with 12.2 percent for all industry. It was only 2.9 percent in finance and insurance, 10.8 percent in trade, and 13.7 percent in manufacturing.

The impact of rising interest rates

There is one remaining point which I desire to call to the attention of the Committee, involving another tremendous liability under which the home building sector has suffered. My Chart 28 shows that, comparing the average for 1952 with December 1968, the mortgage yield on new FHA-insured homes rose from 4.29 percent to 7.13 percent, an advance of 66.2 percent (it is much higher now). To be sure, as shown on the chart, other types of bond yields and interest rates have risen far more. Nonetheless, as we all know, the home building industry has been hurt far more seriously by tight money and rising interest rates than almost any other sector. This is because the Government, as well as business in general, finances only a small proportion of its outlays with borrowed money, while the home building industry and home owners, almost by definition do just the reverse. The adverse impact of rising interest rates upon urban commercial construction is also very great.

It is in fact a gross understatement to say this: The increased costs imposed upon the home building industry and upon home ownership by rising interest rates have been much greater than the net value of benefits conferred in the form of Federal tax concessions and subsidies. This is another example, and a most serious one, of national policies moving in opposite directions simultaneously.

I have very recently made the following estimate: From 1952 through 1968, the average interest rates on all 1-4 family nonfarm home mortgages (not the interest rates on new loans, which rose more than twice as much) rose 43.7 percent. During 1953-1968 as a whole, this imposed an additional interest burden of 17.4

billion dollars, compared with what interest costs would have been if they had remained at the 1952 level. Even if interest costs are soon stabilized or somewhat reduced, these costs will continue to spiral upward until the interest rates on new borrowings are no higher than the average interest rates on existing loans. And this will not come to pass in the foreseeable future. As I have already indicated, the toll imposed upon housing and other real estate investment by rising interest rates exceeds many, many times the benefits conferred upon these lines of endeavor by all tax concessions to them in their current form.

Summary of ~~specific~~ foregoing housing and real estate portions of testimony: relevance of LTD

In summary of this phase of my discussion, our urban areas are in deep and increasing trouble. They must be resuscitated and renewed. Investment in residential and commercial structures, on a vastly expanded scale, is essential to these purposes. Although the Federal Government has asserted the high priority of these purposes, it has not made manifest that high priority in the relative tax and subsidy help which it has extended to residential and commercial investment.

On the revenue side, any recoupment which the Federal Government might achieve through even less favorable treatment of these sectors would be a mere bagatelle, compared with the potentials for recouping revenues in other ways. Further- such action would deal a further blow to sectors which imperatively requires even more encouragement than they have been receiving.

In saying this, I stress again that I am entirely in favor of rigorously limiting total allowable tax deductions (LTD), so that none of those in housing and other real estate or elsewhere shall continue to avoid their decent tax responsibilities. But as I have said, the proper way to get at this problem is through LTD, not by placing further ad hoc curbs upon nationwide endeavors which need additional stimulation.

It should be noted, in this connection, that the current Bill withdraws accelerated depreciation from some industries and not from others, presumably on the ground that some industries should be further restrained and that others -- such as trucking and airlines -- should not be so restrained. But insofar as this withdrawal of accelerated depreciation is designed to get at individuals or business entities which are "getting away with something", it is manifest that such practices may exist in various industries, regardless of whether or not they are deemed to be in need of further stimulation or further restraint. This in itself indicates that the withdrawal of accelerated depreciation is a blunderbuss and in fact erroneous tool for getting at those who are "getting away with something", in that it disregards the larger question of the condition of the industry affected thereby, and whether such industry needs further stimulation or further restraint. And if the withdrawal of some current tax benefits from housing and other real estate investment is predicated upon the notion that they should have imposed upon them further restraints, while other industries should not, this notion can find no support in actual economic, financial, or public policy considerations. Nor can it be reconciled with the mandate of our great national priorities.

I therefore respectfully submit that it would not be desirable to reduce on net balance the help and encouragement which housing and other aspects of real estate investment are receiving from the Federal Government. The generally laudable purpose to close what are some loopholes in this sector should not be permitted to carry the day, in view of the far more important damage and dangers which would flow from any such course of action. LTD, strengthened even beyond the provisions of the Bill in its present form, is the proper approach to this generally laudable purpose.

Detailed Discussions Of Specific Provisions Of The Bill Relating To Housing And Nonresidential Construction

The larger issues

I now come to my analysis and conclusions with respect to those provisions of the current Bill which bear directly and specifically upon housing and nonresidential construction.

But before proceeding with this phase, I want to warn against the tendency of some of those involved in these matters to bog down in what I regard as overly technical discussions of details, bordering at times upon the captious. These specific provisions of the Bill, technical though they are, present profoundly important issues of general economic, financial, and social policy. I therefore express my profound conviction that the types of materials which I have thus far presented in this testimony go beyond and rise above the technical details, and constitute definitive reasons for not going ahead with the provisions of the current Bill relating to housing and nonresidential construction.

Putting this in another way, no mere permutations of these technical provisions can, in my view, take the place of reconsideration of the fundamental premises of policy upon which these provisions rest -- premises which I believe to be demonstrably mistaken. To the extent that there is large merit in what I have thus far submitted throughout this testimony, the problem of correction of the detailed provisions of the Bill relating to housing and nonresidential construction is not a matter of detail. These corrections cannot be effectuated through mere refinements, compromise, or hair-splitting.

Another basic reason why I do not want to get too much into the technicalities is that this Committee has been and will be benefited greatly by the technical discussions of many other witnesses. Some of these witnesses may be more conversant with these technical aspects than I am, and most of these witnesses may not deal as extensively as I do with the larger issues toward which my testimony is primarily addressed.

Nonetheless, I feel it incumbent on me to proceed with some, or even considerable, discussion of the detailed and technical provisions of the Bill relating to housing and nonresidential construction. But even in the course of such discussion, for purposes of clarification and completeness, I will again discuss some of the larger issues, and I hope that this will not prove too repetitive of what I have said earlier in my testimony.

Provisions of the Bill directly affecting both housing and nonresidential construction

The current Bill makes no change in the presently allowed double declining balance method for depreciation of new housing, and this has created the impression in some quarters that the Bill does not affect investment in housing at all. Nothing could be farther from the facts. The current Bill contains a number of provisions that are directly injurious to both housing and nonresidential construction. These are listed briefly.

Used buildings (sec. 521). -- For all used buildings acquired after July 24, 1969, the new owner would be required to use straight line depreciation instead of the presently allowable 150 percent declining balance method.

Recapture (sec. 521). -- For all buildings sold after July 24, 1969, the excess of accelerated depreciation over straight-line depreciation, as taken by the original owner, is to be taxed as ordinary income (to the extent of the gain occurring upon sale).

LTP and allocation of deductions (sec. 301, 302). -- For individuals, the excess of actual depreciation claimed on all real property over the straight-line method is considered a tax preference. Under LTP, tax preferences must be included in gross income to the extent that they exceed 50 percent of economic income. Under the allocation of deductions rule (ADR), deductions are disallowed in the proportion allocable to untaxed preference items of economic income. This provision is especially onerous because it requires that excess depreciation be calculated property by property, and in each year.

Limitation on interest deductions (sec. 221). -- Except where interest is incurred in consumption or in a trade or business, the current Bill limits individual interest deductions to investment income plus 25,000 dollars. Since rental of real property on a net lease basis is explicitly denied the treatment accorded a trade or business, owners of real property which they lease on a net basis would be denied interest deductions they can now obtain.

There are some who believe the limitation on interest deductions could be used to disallow interest on a construction loan. Others disagree, feeling that the construction of buildings is a trade or business, not an investment. Be that as it may, the uncertainties in this respect add another disincentive factor which might be serious.

Additional preference item proposed by the Treasury Department. -- Treasury Assistant Secretary Cohen, in his statement before the Committee on September 4, proposed that a new tax preference item affecting real estate be included both in LTP and ADR. The new preference is the excess of interest, taxes, and rentals paid over receipts (if any) during construction.

Adverse effects of provisions affecting both housing and nonresidential construction

The issue of allowable types of depreciation is central to all provisions of the current Bill affecting housing (and other real estate investment), except for the limitation on interest deductions. And even with this provision, as with the new tax preference items proposed by the Treasury, the tax issues are similar to those raised by the tax treatment of depreciation deductions.

The tax effect of accelerated depreciation is to postpone ordinary taxable income from the early years of a project's life, when depreciation deductions are higher than they would be otherwise, to the later years, when these deductions are lower. (Immediate deduction of interest and other expenses, in years when reported income from the investment project is not large enough to cover them, has a similar effect of postponing taxable income.) Postponing taxable income of course postpones taxes, so the effect of accelerated depreciation is an interest-free loan as against straight-line depreciation. Accelerated depreciation is thus more favorable than straight-line depreciation.

But this does not mean that accelerated depreciation is an inequitable tax concession, even in the narrow sense where equity depends solely upon having taxable income equal currently realized economic income. Equity in this narrow sense depends upon having allowable depreciation deductions equal the actual decline in the economic value of a property, and determining the actual decline is a very difficult question of fact.

Assuming for the moment (although I seriously challenge) that some of those who have studied the problem are right in their finding that the actual economic or value depreciation of office buildings, and even of some other real property, is less rapid than straight-line, the primary consequence of allowing accelerated depreciation (under this assumption or finding) is that the postponed ordinary taxable income can be taken at a later date as a capital gain, taxed at favorable rates, instead of as taxable future ordinary income. This is done by selling the property, at some later date, at a price which capitalizes the ordinary income

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expected to accrue after that date. The current Bill is apparently designed to correct this alleged inequity (in the narrow sense of equity) of the present tax laws. But if the finding is incorrect (which I think to be the case), if the decline in economic value actually does occur at the rate of accelerated depreciation, then the capitalized value of postponed ordinary income only offsets what would otherwise appear on an investor's tax return as a capital loss.

In any event, the assumptions and findings which I deem to be so highly questionable (and certainly not supported by adequate empirical testing), have no direct bearing upon the various provisions of the current Bill which affect housing. The most important of the provisions affecting housing are the elimination of accelerated depreciation for purchasers of used buildings, and the recapture provision (sec. 521). These provisions deny the housing investor most of the advantages of the double declining balance method for depreciating new buildings, even though those who have made the findings with which I disagree do not purport to show that accelerated depreciation is inequitably rapid for housing.

The effect of these two provisions on an investor in new housing is double-barrelled, because in two ways it makes the tax treatment of investment in new housing much less favorable than the tax treatment of other investments. First, any time this investor wants to sell his building, the price will be depressed because the buyer cannot take advantage of even 150 percent declining balance depreciation. Second, if the original investor does sell anyway, the Bill requires that any capital gains, up to the excess of accelerated over straight-line depreciation, be taxed as ordinary income. This means that only the postponement of ordinary taxable income, but never its conversion to capital gains, will be possible under the new law. This change might conceivably be desirable if it could be shown conclusively that accelerated depreciation as to housing and other real estate investment is always excessive, and that true economic income were being converted into capital gains. But to my knowledge there has been no such showing as to housing, nor do I believe that such showing can be made. Further, it is probable in many cases that the gain being "recaptured" was never ordinary income in the first place, but rather a wise speculation on the value of a particular capital asset.

I have stated earlier in my testimony that some tightening of the tax treatment of capital gains is desirable, and this conclusion might seem to contradict what I am saying here about recapture. However, it is important to note that the recapture provisions of the current Bill apply only to investments in housing and other real estate, not to capital gains generally. This is why I find these recapture provisions so unwarranted, at a time when housing and other real estate investment should be stimulated relative to other kinds of investment, not depressed.

The combined effect of recapture and of straight-line depreciation for all acquisitions of used buildings is to make investment in residential construction much less liquid than it is presently. Since housing generally has such a long life, any decrease in liquidity is apt to depress severely investment in housing, and this is patently undesirable. It is recognized that rapid turnover is a problem, and that present phasing out of recapture may be viewed by some as inadequate to prevent unduly rapid turnover. In that case, full recapture of excess depreciation could be extended to five years, with the recaptured percentage of the excess depreciation declining by one percent per month for 100 months thereafter.

Recapture and straight-line depreciation for used buildings are not the only provisions adverse to housing. The limitation on tax preferences (sec. 301), the allocation of deductions (sec. 302), and the limitation on interest deductions (sec. 221) also affect housing (and other real estate investment) adversely.

LTP prevents investors in housing from taking the full benefit of accelerated depreciation, where the amounts involved (when combined with any other tax preferences the taxpayer may have) exceed 50 percent of economic income. ADR requires that investors in housing (and other real estate) allocate some of their deductions to the excess of accelerated depreciation over straight-line depreciation, leaving lesser amounts to be deducted from income subject to taxation, and this too reduces the benefits that can be obtained from accelerated depreciation. Although these provisions would make investment in housing less attractive to most investors, I believe, as I have explained, that they are the proper way to prevent gross abuse of the tax stimuli favoring investment in housing. However, I do not agree with the Treasury that interest and taxes paid during construction of real property improvements should be included at this time as a tax preference. My reason is that the use of this practice has received much less scrutiny than the use of accelerated depreciation, and it is not clear at this time that treatment of these interest and tax costs as a preference item is justified. It should also be noted that the Treasury proposal discriminates against housing and other real property, in that other kinds of property are not subject to similar tax treatment.

Although I do favor LTP and ADR, as I have explained, I want to emphasize that their application to housing (and other real estate investment) will have an adverse effect. For this reason it is even more important that the other provisions of the Bill damaging to housing not be adopted.

Retroactive features of the Bill, and some other technical problems

Before leaving the subject of housing, I should like to point out some retroactive featuresof the Bill in its current form, and also comment on one other technical problem.

(1) The following sections of the Bill apply retroactively, in that they deny certain tax concessions on commitments made before the Bill was reported. This occurs because the income or deduction accrues after the Bill is effective, and thus is covered by its terms.

(a) Sec. 221, limitation on interest deduction. The problem here is long-term net leases entered into before the Bill was reported. Interest deductions by the lessor may be limited, even though the investor has a long-term commitment. Also, the lessor is not making unreasonably high after-tax returns over the life of the project -- the effect of tax concessions, at least in significant part, is passed on to the lessee in the form of lower rental prices than would otherwise obtain:

(b) Sec. 301 and 302, LTP and allocation of deductions. Accelerated depreciation of real property is a tax preference for purposes of LTP and allocation of deductions. Even where a transaction has been committed before the Bill was reported, the transactor loses some benefit from accelerated depreciation. The allocation of deductions is most serious, because it hurts all amounts of accelerated depreciation. The LTP only hurts if the taxpaper has excess depreciation amounts greater than his other income;

(c) Sec. 521, recapture of accelerated depreciation. Persons who invested in real estate before the Bill was reported may have done so only in expectation of converting some income to future capital gains, and they have offered lower rentals in anticipation of this tax advantage. The rental commitments continue, but the tax advantage is gone.

(2) The allocation of deductions to untaxed excess depreciation would not operate fairly. A taxpayer taking accelerated depreciation only postpones taxable

income (and perhaps converts later to capital gains, but not as sec. 521 is now written). However, deductions disallowed are lost forever. Therefore, deductions disallowed on account of excess real estate depreciation should be added back to basis cost for purposes of later determining capital gain. (This treatment would correspond to the treatment of that part of excess depreciation which is itself disallowed under LTP).

Provisions of the Bill directly affecting nonresidential construction, and their effects

In addition to all the provisions adversely affecting both housing and other real estate investment, there is one very important provision in the current Bill which applies only to nonresidential construction. This provision, in sec. 521, would limit the use of accelerated depreciation by the original owner of new nonresidential structures to the 150 percent declining balance method, instead of the presently allowed double declining balance method. The 150 percent method is substantially slower than the 200 percent (double declining balance) method, and it therefore reduces very substantially the incentives for investment in nonresidential construction.

The reason given for treating housing and nonresidential construction differently is that "Congress [has] expressed its desire to stimulate construction in low- and middle-income housing to eliminate the shortage in this area" (Ways and Means Report No. 91-413, Part 1, p. 166). However, as I have developed in detail earlier in my testimony, it is entirely unrealistic to posit that better housing in a better environment can be achieved by stimulating residential construction alone. Proper community development requires the blending and integration of housing, appurtenant community facilities, and commercial structures. Without the latter, developers may be unable to open up new areas for housing, because no one wants to live where there are no stores, amusements, or other attractions. This is especially true of low-income persons, because they are known to be much less mobile than persons with higher incomes (the two-car family can live where it pleases; the one-car or no-car family cannot).

Within the cities, it is especially desirable to encourage the development of commercial structures, because such buildings increase the tax base and provide the cities with sorely needed revenues. These revenues are obtained without placing additional tax burdens on urban residents, and they may thus help to stem or reverse the flow of middle-income families away from the cities, allowing a better mixture of income groups in all residential loci.

It should be clear, therefore, that there is no sound basis for limiting the tax advantages of the double declining balance method only to new housing, because proper and full development of the nation's housing requires a correlative stimulus for nonresidential construction.

The need for favorable tax treatment of new nonresidential construction can also be developed from a more general approach, comparing commercial construction with other sectors of the economy (commercial construction is the largest component of nonresidential, nonfarm buildings, and it is the one on which the Bill in its current form concentrates). As my earlier discussion indicates (see again Charts 22 and 23), investment in both housing and commercial structures has been growing much less rapidly than other forms of investment, although sound national economic and social policy requires that both of these sectors grow much more rapidly than they have been growing, and also more rapidly than GNP and other major components thereof.

The deficiency in the pace of housing investment is clearly much greater than in the pace of investment in commercial structures, but that is no reason for removing tax advantages from the latter. The present tax advantages for commercial construction are inadequate in terms of our national needs, and they should be strengthened rather than weakened. In this connection, it should be observed that the current Bill places as great an additional burden on investment in nonresidential real estate as it does on investment in producers' durables. The repeal of the investment tax credit, the only provision directly affecting investment in producer durables, is expected to yield 3.3 billion dollars in 1979, when fully effective (projections based on current volume of activity -- see H.R. Report 91-413, Pt. 1, p. 16). This is only 5.6 percent of the 1968 investment in this category. In contrast, the reduction in accelerated depreciation on new nonresidential buildings alone is expected to yield 960 million dollars, or 5.1 percent of the 1968 investment in such buildings, and the other tax provisions affecting real estate will certainly increase substantially the tax effect on new construction in this field, although the Committee Report does not give revenue estimates in sufficient detail to determine these effects exactly.

The immediately preceding discourse implicitly assumes that there is merit in the proposition that commercial buildings (if not housing) depreciate (in an economic or value sense) less rapidly that straight line. For reasons already stated, this proposition has nowhere to my knowledge been vindicated, nor do I agree with it. A recent study by Taubman and Rasche,* made available to the U.S. Treasury, may well have attained some influence in directions contrary to those I recommend. My analysis of this study, showing its shortcomings, is attached as Appendix Two.

The foregoing indicates that the current tax treatment of all real estate invest-

* P. Taubman and R.H. Rasche, "Economic and Tax Depreciation of Office Buildings" (University of Pennsylvania, Wharton School of Finance and Commerce, Department of Economics, Discussion Paper No.111, January 1969).

ment, both housing and nonresidential, is desirable on the general grounds of public economic policy. However, the current Bill is directed more narrowly to the question of tax equity, and it is important that the tax equity arguments be faced on their own grounds, even though I feel that these grounds are not the best grounds for resolving the basic issues of our national needs for accelerated investment in these sectors.

Equitable considerations

It must be emphasized that tax concessions to the real estate industry do not "enrich" real estate investors generally, as shown on my earlier Chart 27. Thus, the current tax concessions available to real estate enable lower rents than would otherwise obtain, and stimulate construction, but they do not provide real estate investors generally with inordinate gains. This indicates that the equity issue may be somewhat specious: investors in real estate generally are no better off after paying their (allegedly) reduced taxes than other investors paying (allegedly) higher taxes.

The question of equity is thus transformed into a question of resource allocation -- is it proper that real estate continue to receive the economic stimulus they now receive from current tax provisions? I feel that the materials I have incorporated in this testimony provide an affirmative answer to this question.

Additional considerations

The increasing burden of State and local property taxes weighs most heavily upon residential and commercial construction, and indeed upon the owners and renters of such properties, including average business people and, most importantly, families of low and lower-middle income. Federal tax concessions for real estate thus serve in part to redress the balance, not disturb it (and they are also a way for the

Federal Government to ease the plight of the States and localities).

Second, as already discussed, high interest rates are more burdensome to housing and other aspects of real estate investment than to other industries, because these endeavors are much more dependent upon external financing (rather than retained earnings) and upon debt financing (see again Chart 27). These high interest rates, however, are not necessarily a true measure of either the scarcity or the value of capital for investment, but rather they are contrived by Government policy. It is therefore extremely appropriate that tax concessions to real estate be used to offset some of the distortions caused by artificially high interest rates.

Third, most other forms of investment will retain the advantages of shortened guideline lives and accelerated depreciation, and similar treatment of real estate is again a balancing force rather than a disturbing one.

Consideration of these three factors is an application of what is called the theory of second-best. As a general principle, subsidy for one industry leads to inefficient allocation of resources; but this principle applies only when there are no taxes or subsidies for any other industries. Viewed against the background of an established tax structure, containing many different types of taxes imposed by many different jurisdictions, the simple rule that subsidies cause inefficiency can no longer be applied (if it has any large validity in principle). Given the present tax structure, it seems clear that continued Federal income tax concessions for real estate are appropriate. Of course, major changes in other parts of the structure might be desirable, and it might then become desirable also to modify the tax treatment of housing and other aspects of real estate investment, but that is not a controlling factor at this time.

Another broad class of reasons for applying only with caution the general rule that subsidies, including those in the form of tax concessions, are inefficient is the incidence of external economies and diseconomies. External factors exist which cause the private signals of market prices to register only partially and inaccurately the values of everyone in the economy. Where this happens, collective action to redirect market incentives is appropriate, and special concessions become necessary. The whole field of housing, urban development, and land use is a classic example of external effects, and there are many economists who argue that such concessions for real estate development are in fact necessary for economic efficiency, not inimical to it.

Finally, in a period of inflation, the Federal tax structure (and income taxes generally) imposes an especially heavy burden on investors holding assets with relatively long lives. The problem is the tax treatment of depreciation allowances, which supposedly enable a taxpayer, in determining his income, to deduct from his revenues the amounts that are only a recovery of his initial capital costs. Taxation is based upon the principle that a dollar is a dollar, whenever it is received or paid, and the owner of property can only obtain depreciation allowances equal to his original dollar cost, even though some of the depreciation is taken many years after the cost was incurred. This means that, in a period of general inflation, the depreciation dollars deducted from revenue, which are supposed to constitute recovery of cost, are worth less (in purchasing power) than those used to construct or acquire the property. The result is that the taxpayer must pay income taxes on funds whose receipt is necessary just to maintain the value (in goods) of his investment (see Table 1).

The first column of the table shows what would happen in some arbitrary future year t, on the assumption that there is no change in the general price level. Revenues, costs and taxes are listed, and in this hypothetical example there is a cash flow (depreciation plus income after tax) equal to 15 percent of the assumed

Table 1

Effect of Inflation on Income and Taxation
of Owners of Depreciable Property

Year zero

Price index	100
Initial cost of property	$500,000

Year t

Assumed price level	100	200	300
Revenues	$180,000	$360,000	
Operating and maintenance cost	120,000	240,000	
Gross return to capital	60,000	120,000	120,000
Depreciation allowed	30,000	30,000	60,000
Taxable income	30,000	90,000	60,000
Income tax	15,000	45,000	30,000
Income after tax	15,000	45,000	30,000
Cash flow after tax	45,000	75,000	90,000
Current value of property	300,000	600,000	600,000
Cash flow as percentage of current value	15.0	12.5	15.0

Note: All data are artificially constructed for this example.

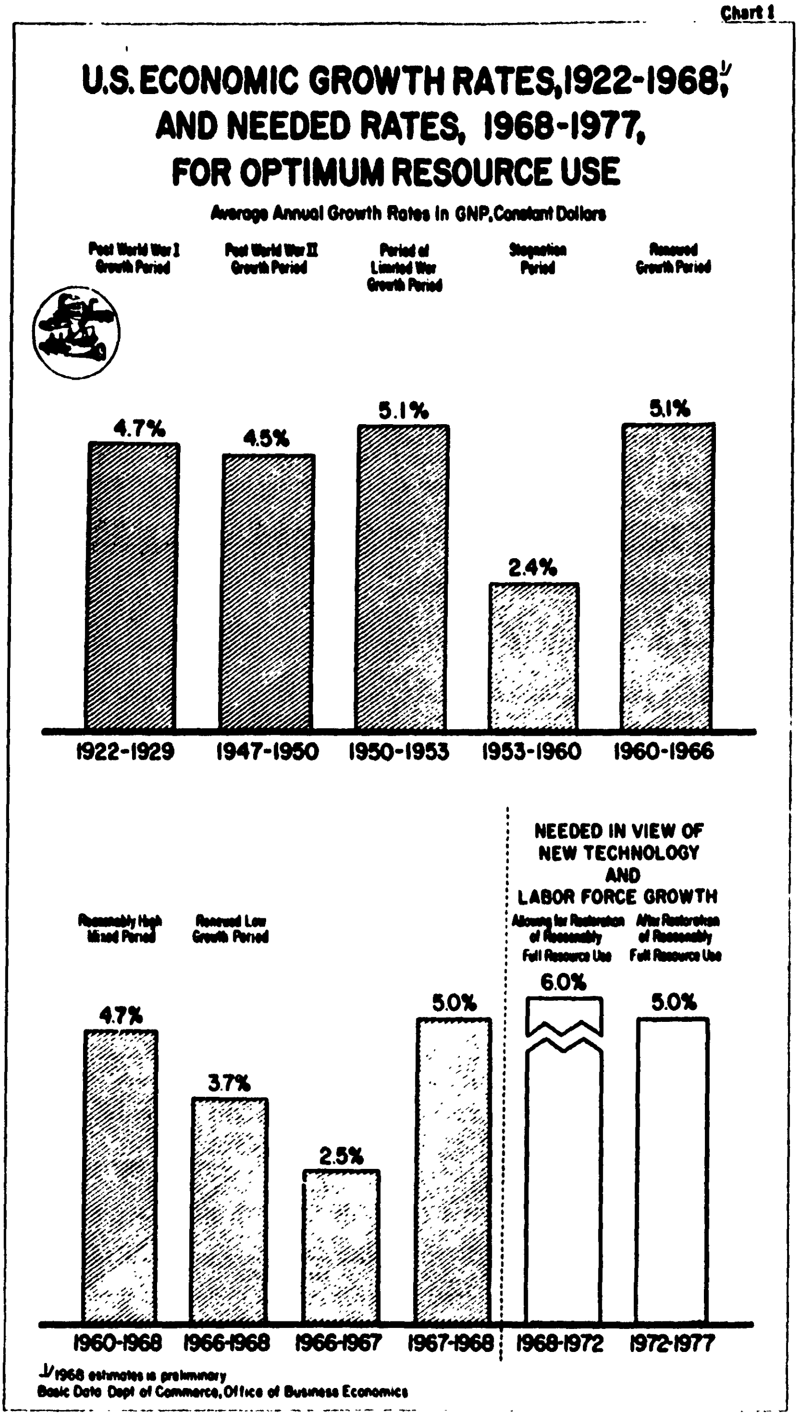
value of the property in that year. This cash flow represents both the recovery of the investor's cost and his income from the investment.

The second column of the table shows what would happen on the assumption that the price level in year t were double that in year zero, owing to inflation during the intervening period. Revenues, current costs, and the current value of the property are double what they would be with the price index at 100. Allowable depreciation, however, is not doubled, so that taxable income and thus income taxes are more than doubled (in this example, income tax is tripled). The result is that cash flow is less than doubled, and cash flow is therefore a smaller percentage of the property's value than it would be in the absence of inflation.

The third column shows how a doubling of the depreciation allowance (in proportion to the amount of inflation) would exactly compensate for the effect of inflation, reducing income taxes to twice the amount that would be collected in the absence of inflation, and thus restoring cash flow to the same percentage of current value as would be obtained if no inflation had occurred.

I do not contend that depreciation, for tax purposes, be calculated on a basis other than recovery in current dollars of initial cost -- any change would make administration of the tax laws very much more difficult. However, it should be observed that office buildings have longer lives than most other assets, so the effects described here have a greater impact on them than on, say, investment in producer durables. For this reason one should perhaps make other adjustments in the handling of depreciation for long-lived assets, and shorter guideline lives plus accelerated depreciation seem appropriate.

Chart 1



U.S. ECONOMIC GROWTH RATES, 1922-1968[1], AND NEEDED RATES, 1968-1977, FOR OPTIMUM RESOURCE USE
Average Annual Growth Rates in GNP, Constant Dollars
Post World War I Growth Period
Post World War II Growth Period
Period of Limited War Growth Period
Stagnation Period
Renewed Growth Period
4.7%
4.5%
5.1%
2.4%
5.1%
1922-1929
1947-1950
1950-1953
1953-1960
1960-1966
NEEDED IN VIEW OF NEW TECHNOLOGY AND LABOR FORCE GROWTH
Reasonably High Mixed Period
Renewed Low Growth Period
Allowing for Restoration of Reasonably Full Resource Use
After Restoration of Reasonably Full Resource Use
4.7%
3.7%
2.5%
5.0%
6.0%
5.0%
1960-1968
1966-1968
1966-1967
1967-1968
1968-1972
1972-1977
[1] 1968 estimates is preliminary
Basic Data Dept of Commerce, Office of Business Economics

Chart 2

COSTS OF DEFICIENT ECONOMIC GROWTH U.S. ECONOMY, 1953-1968 AND 1969-1977

(dollar items in billions of 1967 dollars)

1953-1968

Total National Production (GNP)	Man-years of Employment[1]	Personal Consumption Expenditures	Gov't Outlay for Goods and Services
1953-1968: $ 917.8 1968: 81.8	1953-1968: 38.6 Million 1968: 2.1 Million	1953-1968 $692.8 1968: 73.1	1953-1968 $32.9 1968: -11.7
Private Business Investment (Incl. Net Foreign)	**Average Family Income**	**Wages and Salaries**	**Unincorporated Business and Professional Income**
1953-1968: $192.1 1968: 20.4	1953-1968: $11,459 1968 1,208	1953-1968: $637.2 1968 67.3	1953-1968: $79.4 1968 8.4

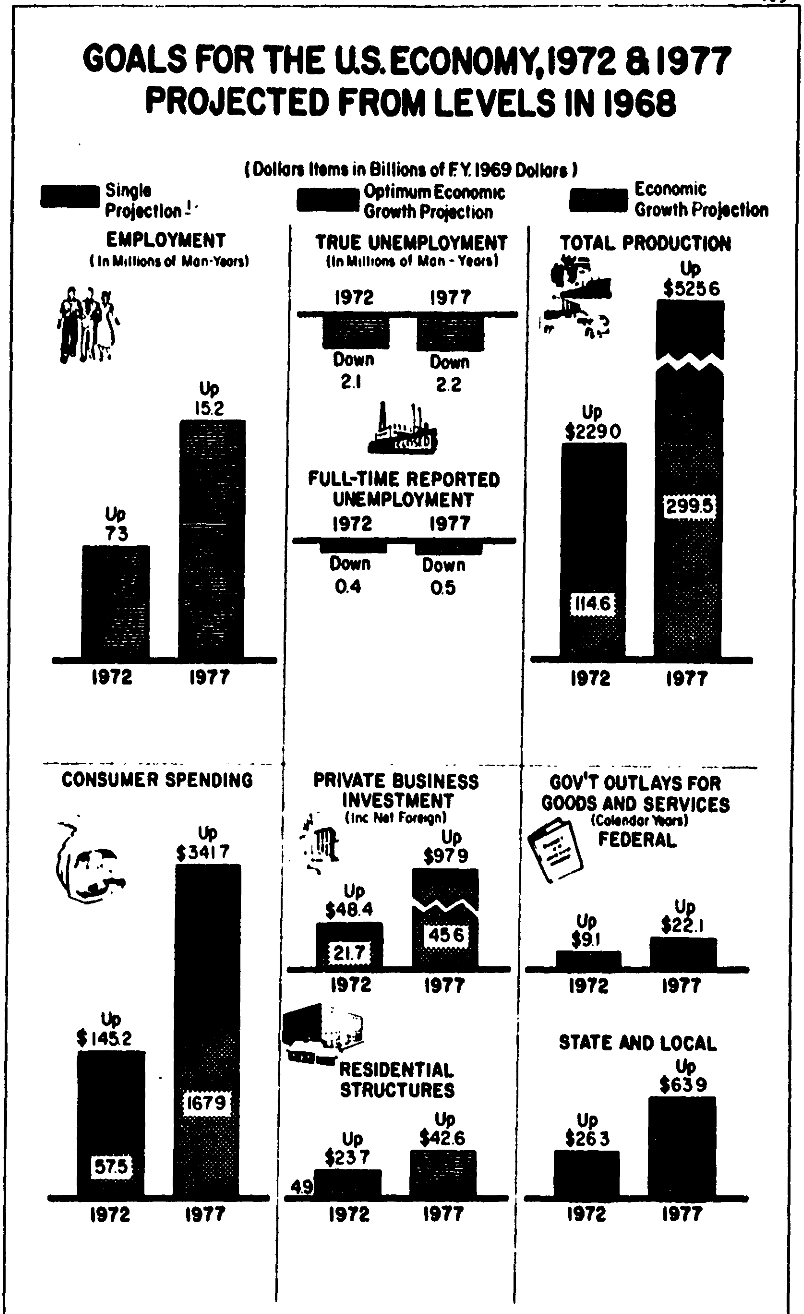
1969-1977

Total National Production (GNP)	Man-years of Employment[1]	Personal Consumption Expenditures	Gov't Outlay for Goods and Services
1969-1977 $1,173.7 1977 215.4	1969-1977: 31.4 Million 1977: 5.0 Million	1969-1977: $ 764.0 1977: 144.4	1969-1977: $146.1 1977: 27.2
Private Business Investment (Incl Net Foreign)	**Average Family Income**	**Wages and Salaries**	**Unincorporated Business and Professional Income**
1969-1977: $263.6 1977: 43.8	1969-1977: $ 11,958 1977: 2,349	1969-1977: $ 702.7 1977: 132.8	1969-1977 $ 87.6 1977: 16.6

[1] Based upon true level of unemployment concept, including full-time unemployment, full-time equivalent of part-time unemployment, and concealed unemployment (nonparticipation in civilian labor force) due to scarcity of job opportunity

Basic Data: Dept. of Commerce, Dept. of Labor

Chart 3



1/ The single projections relate to goals of such high priority that they should not be reduced even if only the lower goals for GNP are attained. In that event, lower priority objectives should be modified accordingly.

Chart 6

GOALS FOR A FEDERAL BUDGET, 1972 AND 1977, GEARED TO ECONOMIC GROWTH & PRIORITY NEEDS

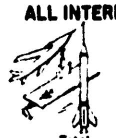
1969, fiscal year; goals for 1972 and 1977, calendar years

All figures in fiscal 1969 dollars [1]

ALL FEDERAL OUTLAYS

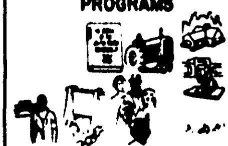
Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	186.062	917.01	21.02
1972	226.500	1,068.90	20.61
1977	280.000	1,223.77	20.06

NATIONAL DEFENSE, SPACE TECHNOLOGY, & ALL INTERNATIONAL



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	89.515	441.18	10.11
1972	90.000	424.73	8.19
1977	94.000	410.84	6.73

ALL DOMESTIC PROGRAMS



Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	96.547	475.84	10.91
1972	136.500	644.17	12.42
1977	186.000	812.93	13.32

ECONOMIC OPPORTUNITY PROGRAM

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	2.000	9.86	0.23
1972	3.800	17.93	0.35
1977	5.500	24.04	0.39

HOUSING AND COMMUNITY DEVELOPMENT

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	2.784	13.72	0.31
1972	5.500	25.96	0.50
1977	9.000	39.34	0.64

AGRICULTURE; AND NATURAL RESOURCES

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	8.099	39.91	0.91
1972	12.000	56.63	1.09
1977	15.500	67.75	1.11

EDUCATION

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	4.699	23.16	0.53
1972	16.200	76.45	1.47
1977	32.900	143.79	2.36

HEALTH SERVICES AND RESEARCH

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	10.655	52.51	1.21
1972	14.000	66.07	1.27
1977	20.000	87.41	1.43

PUBLIC ASSISTANCE; LABOR, MANPOWER, AND OTHER WELFARE SERVICES

Year	Total Expend. (Bil. $)	Per Capita ($)	% of GNP (%)
1969 [2]	6.280	30.95	0.69
1972	9.500	44.83	0.86
1977	15.100	66.00	1.08

1/ Dollars of purchasing power apparently assumed in President's fiscal 1969 Budget

2/ Administration's Proposed Budget as of Jan 29, 1968. Beginning with fiscal 1969, the Budget includes the immense trust funds, net lending, and other relatively minor new items. Note: Goals include Federal contributions of one billion in 1970, and more than two billion in 1977, to the OASDHI to help increase benefit payments to the aged.

Projections by Leon H. Keyserling

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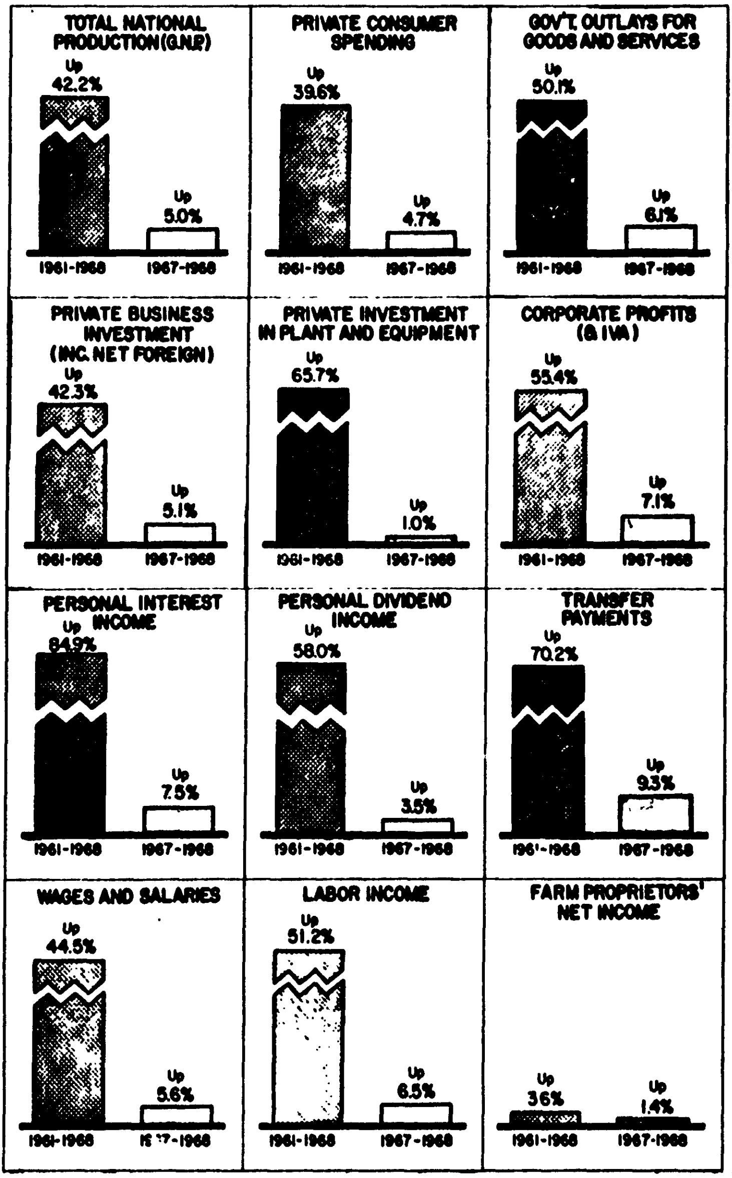
COMPARATIVE GROWTH IN VARIOUS ASPECTS OF U.S. ECONOMY 1961-1968

(Constant Dollars)

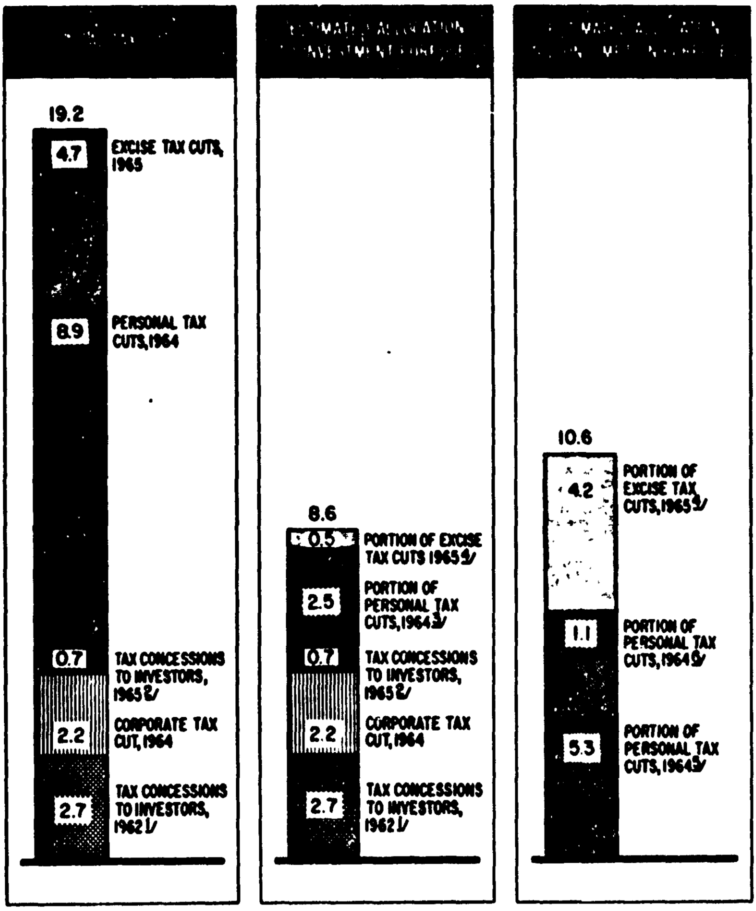


Source: Dept of Commerce, Office of Business Economics and CEP.

Chart 6

ALLOCATION OF TAX CUTS, 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



1/ Through Congressional & Executive Action

2/ Through Executive Action

3/ Estimated portion of personal tax cut, for those with incomes of $10,000 and over, which they would save for investment purposes.

4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.

5/ Personal tax cuts for those with incomes under $10,000.

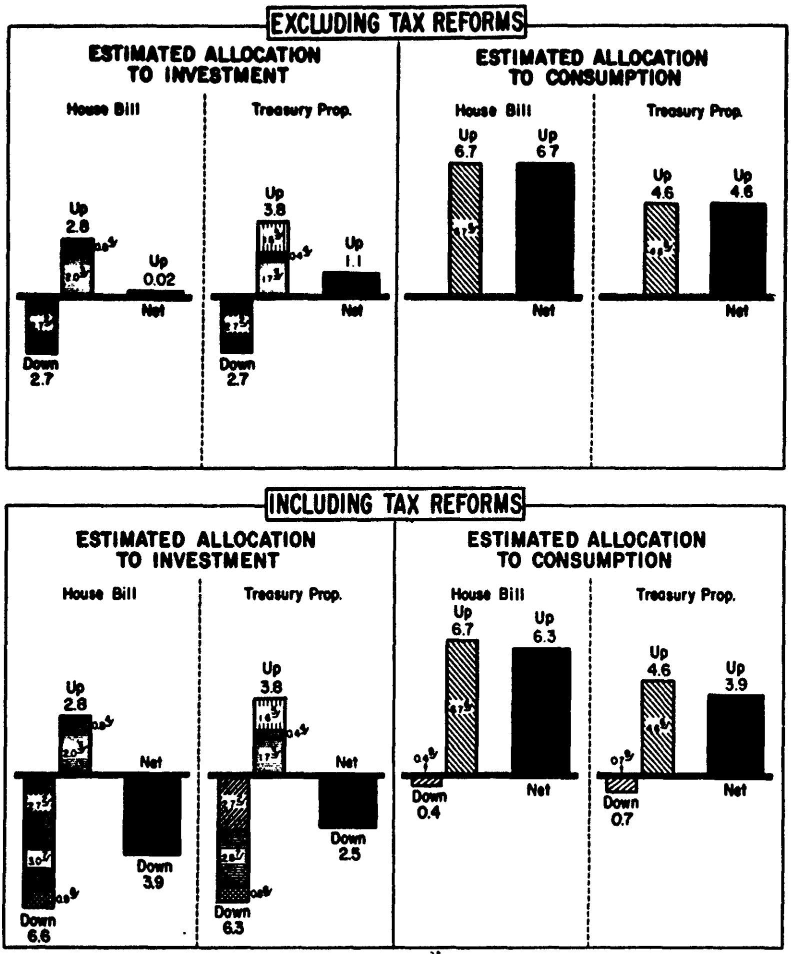
6/ Estimated portion of personal tax cuts for those with incomes of $10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions) However, a large portion of this did not go to low income consumers.

Chart 7

ESTIMATED DIVISION OF PROPOSED TAX CUTS BETWEEN INVESTMENT AND CONSUMPTION

(Billions of Dollars 1/)



1/ Totals may not be exactly equal to sum of details shown, owing to rounding.

2/ Repeal of investment tax credit, effect on corporations.

3/ Estimated impact on personal saving of personal tax relief - and of individuals' share in repeal of investment tax credit.

4/ Investment incentives to corporations.

5/ Corporate tax relief.

6/ Estimated impact on personal consumption expenditure of personal tax relief and of individuals' share in repeal of investment tax credit.

7/ Effect of tax reforms on corporations.

8/ Estimated impact of tax reforms on personal saving.

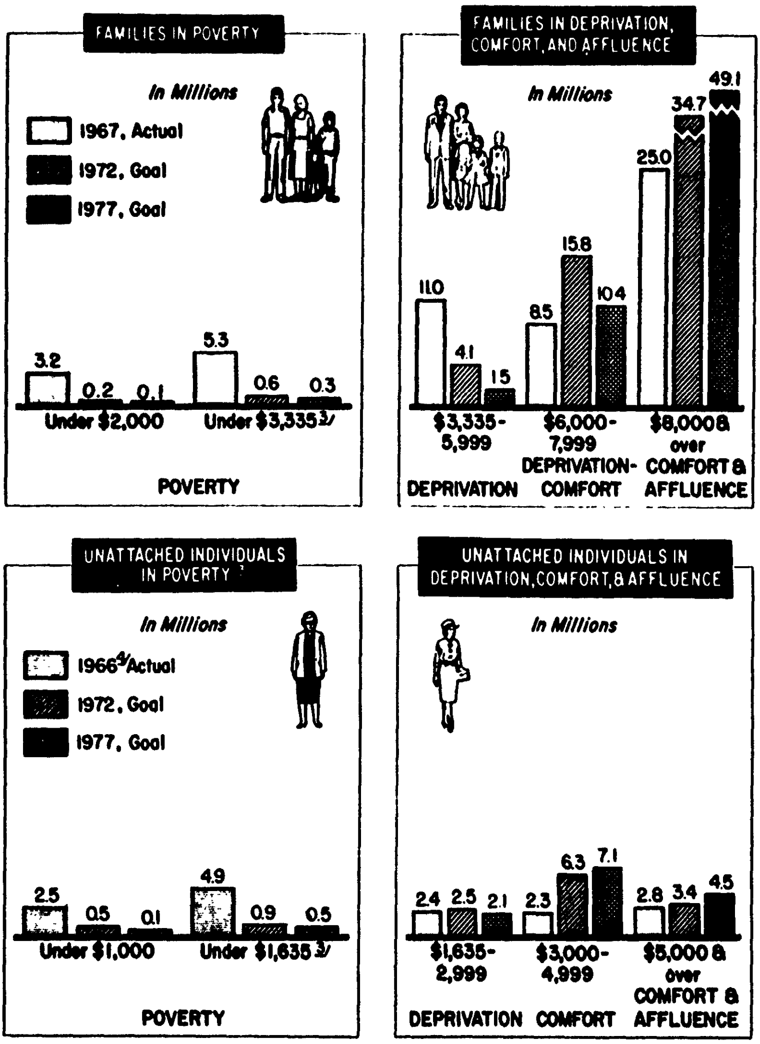
9/ Estimated impact of tax reforms on personal consumption expenditure.

Source: Basic data from Report of House Ways and Means Committee, and from statement of Treasury Assistant Secretary Cohen, September 4, 1969

Chart 8

NUMBER IN U.S. LIVING IN POVERTY, DEPRIVATION, COMFORT, AND AFFLUENCE, 1967, AND GOALS FOR 1972 AND 1977

Annual Money Incomes, Before Taxes, in 1967 Dollars



1/ Poverty-income ceilings vary by size of family. The figure of $3,335 applies to a family of four, according to the estimates of the Social Security Administration, Dept. of H.E.W. The average size of families in poverty being four, 5.27 million families involve about 21.1 million people.

2/ The average size of families living in deprivation is about 3.0, coming to about 33 million people.

3/ The poverty-income ceiling of $1,635 accords with the estimates of the Social Security Administration, Dept. of H.E.W.

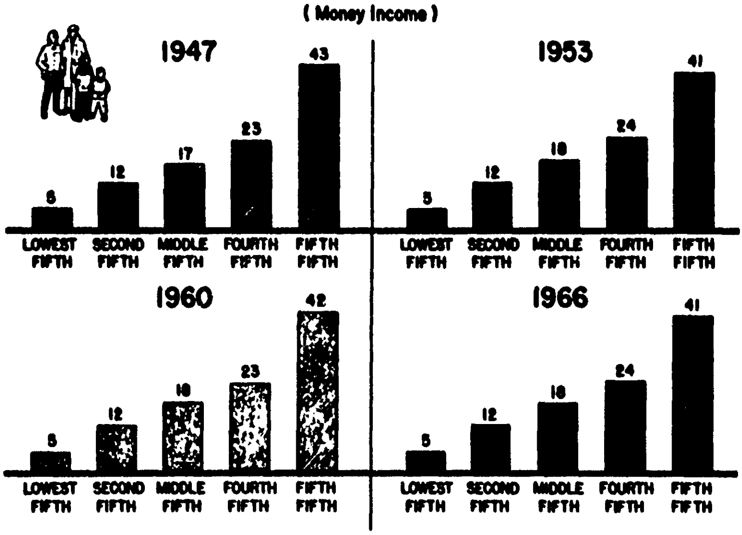
4/ 1967 not available. All projections, however, in 1967 dollars.

Basic Data: 1966, 1967: Social Security Administration, Dept. of H.E.W.; Bureau of the Census, Dept. of Commerce.

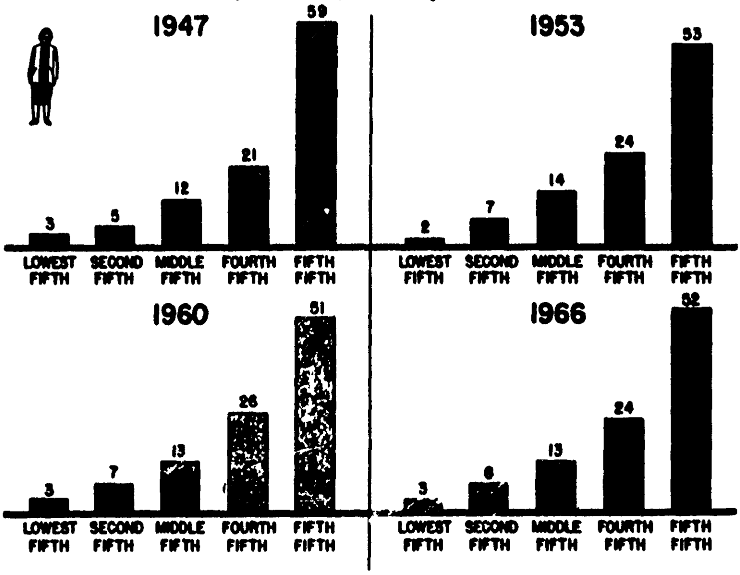
Chart

SHARE OF FAMILIES IN TOTAL FAMILY INCOME BY QUINTILES, 1947, 1953, 1960, and 1966

(Money Income)



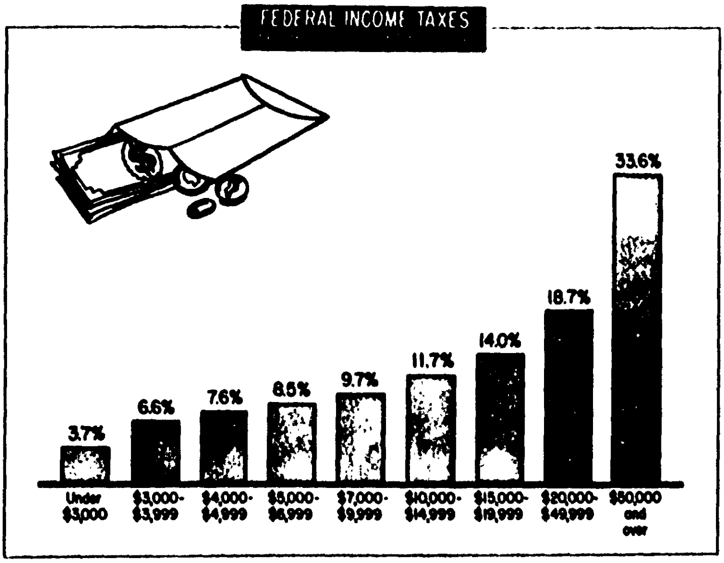
SHARE OF UNATTACHED INDIVIDUALS IN TOTAL INCOME OF UNATTACHED INDIV., BY QUINTILES, 1947, 1953, 1960, and 1966

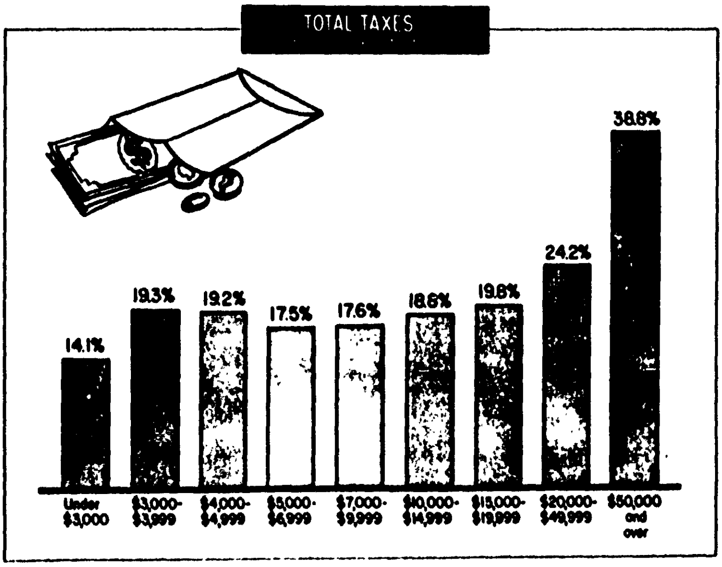


Data: Bureau of the Census.

Chart 10

TAXES PAID AS % OF INCOME, U.S. 1966[1]





1/ Income relates to "Total Gross Adjusted Income" of all persons in the income classes shown.

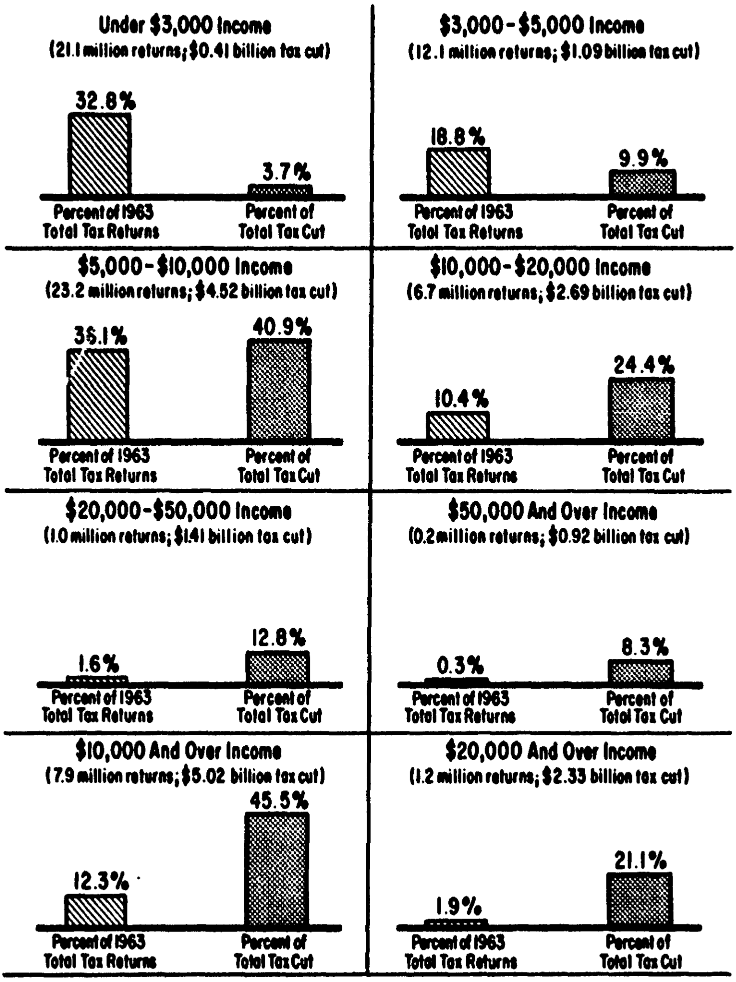
2/ Includes Federal income taxes; social security taxes; State and local income, sales and gasoline taxes; and personal property and real estate taxes

Basic Data: Internal Revenue Service and Brookings Institution

Chart 11

ADMINISTRATION PLAN, PERSONAL TAX CUTS EXCLUDING PROPOSED TAX REFORMS

Distribution Of Total Tax Returns[1] And Of Total Tax Cuts[2] Among Various Income Groups[3]



Estimated 1963 Total Tax Returns-64.3 Million

Estimated 1963 Tax-$47.4 Billion; Proposed Tax-$36.4 Billion; Proposed Tax Cut-$11 Billion

1/ All 1963 returns (taxable and nontaxable). CEP estimates based on Treasury Dept. data.

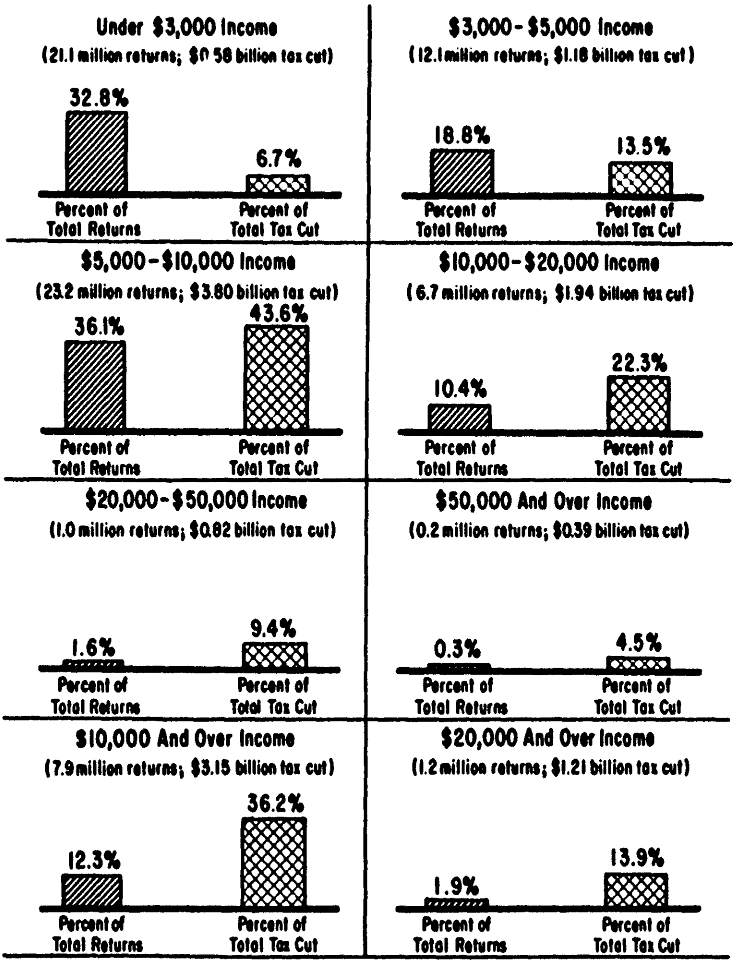
2/ Tax cuts as of 1965 (when plan would become fully effective) as proposed in President's 1963 Tax Message and Treasury Dept. data as of Feb. 6, '63, applied to 1963 income structure.

3/ Adjusted gross income levels as of 1963, estimated by CEP on basis of Treasury Dept. data.

Chart 12

ADMINISTRATION PLAN, PERSONAL TAX CUTS INCLUDING PROPOSED TAX REFORMS

Distribution Of Total Tax Returns[1] And Of Total Tax Cuts[2] Among Various Income Groups[3]



Estimated 1963 Total Tax Returns-64.3 Million

Estimated 1963 Tax-$47.4 Billion; Proposed Tax-$38.7 Billion; Proposed Tax Cut-$8.7 Billion.

1/ All 1963 returns (taxable and nontaxable). CEP estimates based on Treasury Dept. data.

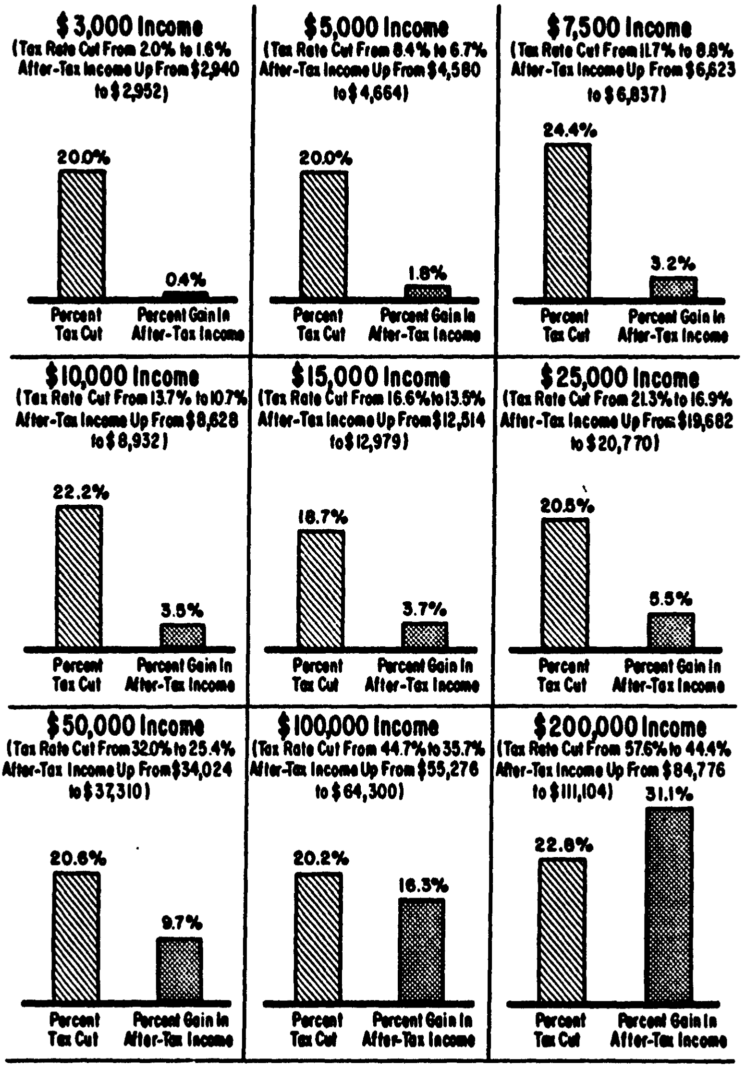
2/ Tax cuts as of 1965 (when plan would become fully effective) as proposed in President's 1963 Tax Message and Treasury Dept. data as of Feb. 6, 1963, applied to 1963 income structure. Effect of capital gains revision excluded.

3/ Adjusted gross income levels as of 1963, estimated by CEP on basis of Treasury Dept. data.

Chart 13

ADMINISTRATION PLAN, PERSONAL TAX CUTS EXCLUDING PROPOSED TAX REFORMS

Percent Tax Cut And Percent Gain In After-Tax Income Married Couple With Two Children At Various Income Levels[1]



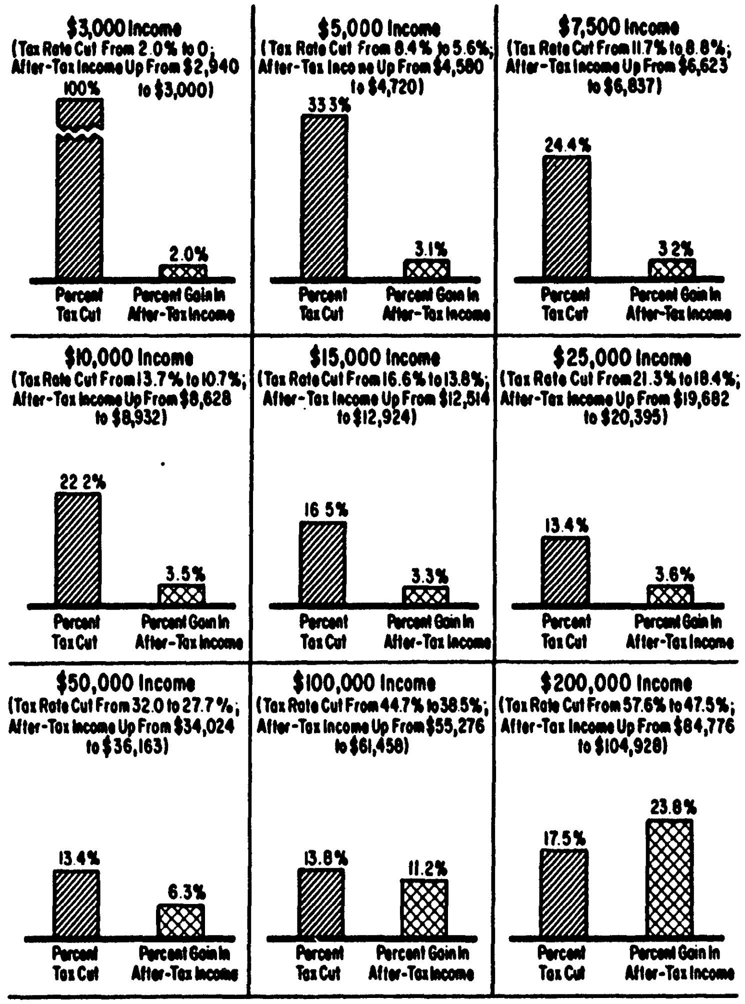
[1] Adjusted gross income levels.

Note: Present and proposed tax based on assumption of 10 percent deductions for taxes, interest, contributions, medical care, etc. Proposed tax based on the President's proposal, and Treasury Dept. data, as of Feb. 6, '63.

Chart 15

ADMINISTRATION PLAN, PERSONAL TAX CUTS INCLUDING PROPOSED TAX REFORMS

Percent Tax Cut And Percent Gain In After-Tax Income
Married Couple With Two Children At Various Income Levels[1]

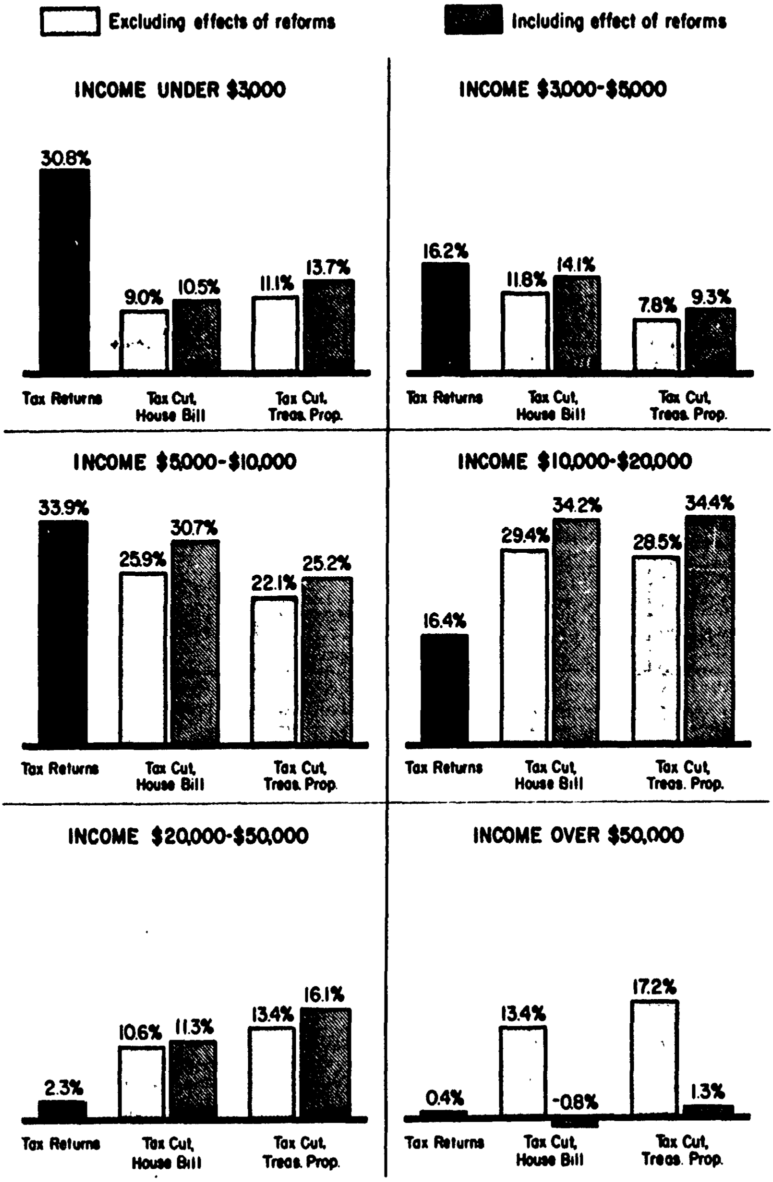


[1] Adjusted gross income levels.

Note: Present tax based on assumption of 10 percent deduction for taxes, interest, contributions, medical care, etc. Proposed tax based on the President's proposal, and Treasury Dept. data, as of Feb. 6, '63.

Chart 15

PERCENTAGE DISTRIBUTION OF TAX RETURNS[1] AND OF PROPOSED TAX CUTS[2] AMONG VARIOUS INCOME GROUPS[3]



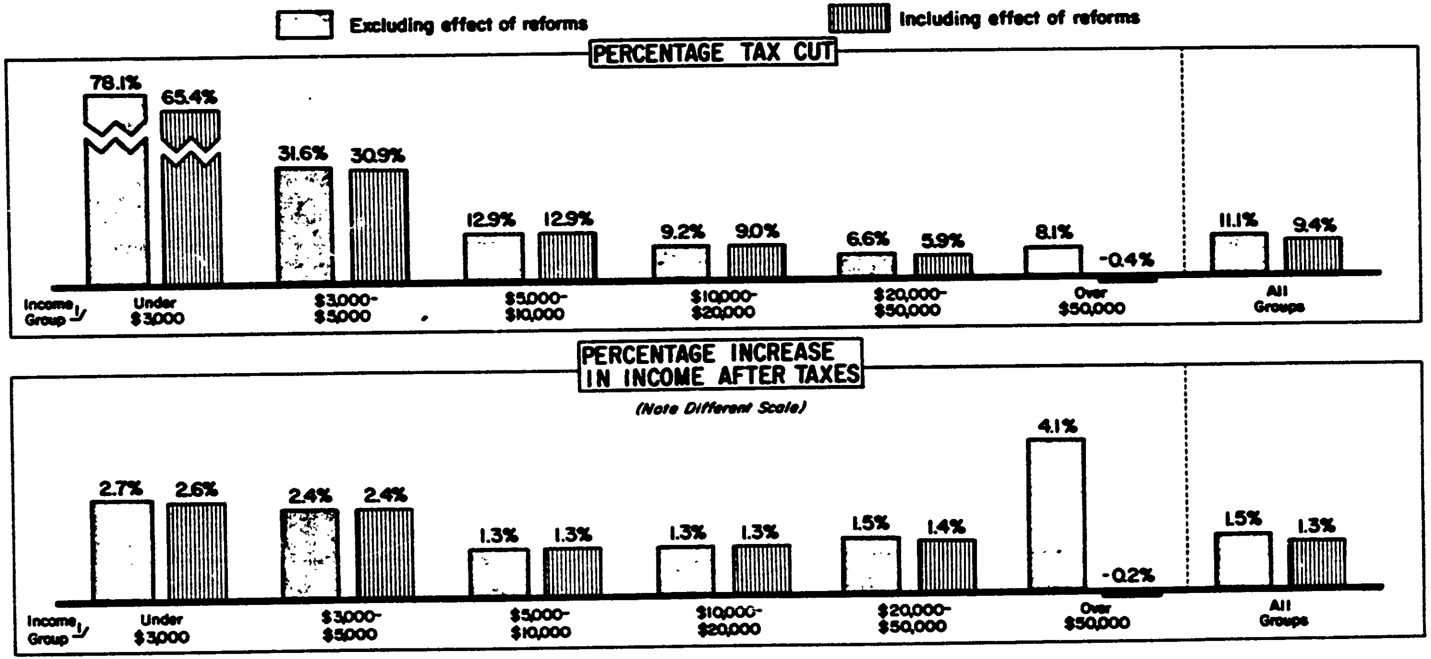
[1] All 1966 individual income tax returns (latest year available): Treasury Dept., Internal Revenue Service, Statistics of Income.

[2] H.R. 13270 and Treasury Proposal of September 4, 1969. Basic data from statement of Treasury Secretary Kennedy and Assistant Secretary Cohen.

[3] Adjusted gross income classes.

Chart 16

HOUSE BILL, PERCENTAGE TAX CUT AND PERCENTAGE INCREASE IN INCOME AFTER TAX, VARIOUS INCOME GROUPS

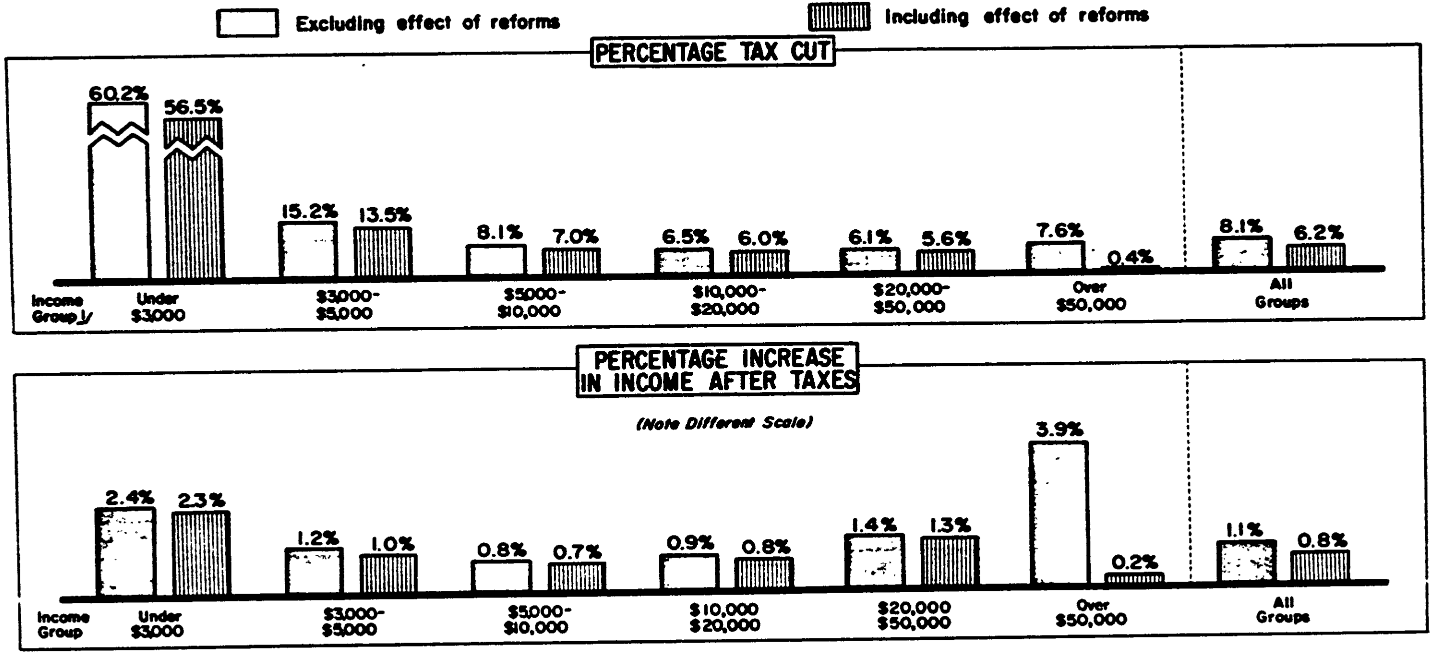


1/ Adjusted gross income class.

Source: Basic data from Report of House Ways and Means Committee, accompanying H.R. 13270

Chart 17

TREASURY PROPOSAL, PERCENTAGE TAX CUT AND PERCENTAGE INCREASE IN INCOME AFTER TAX, VARIOUS INCOME GROUPS

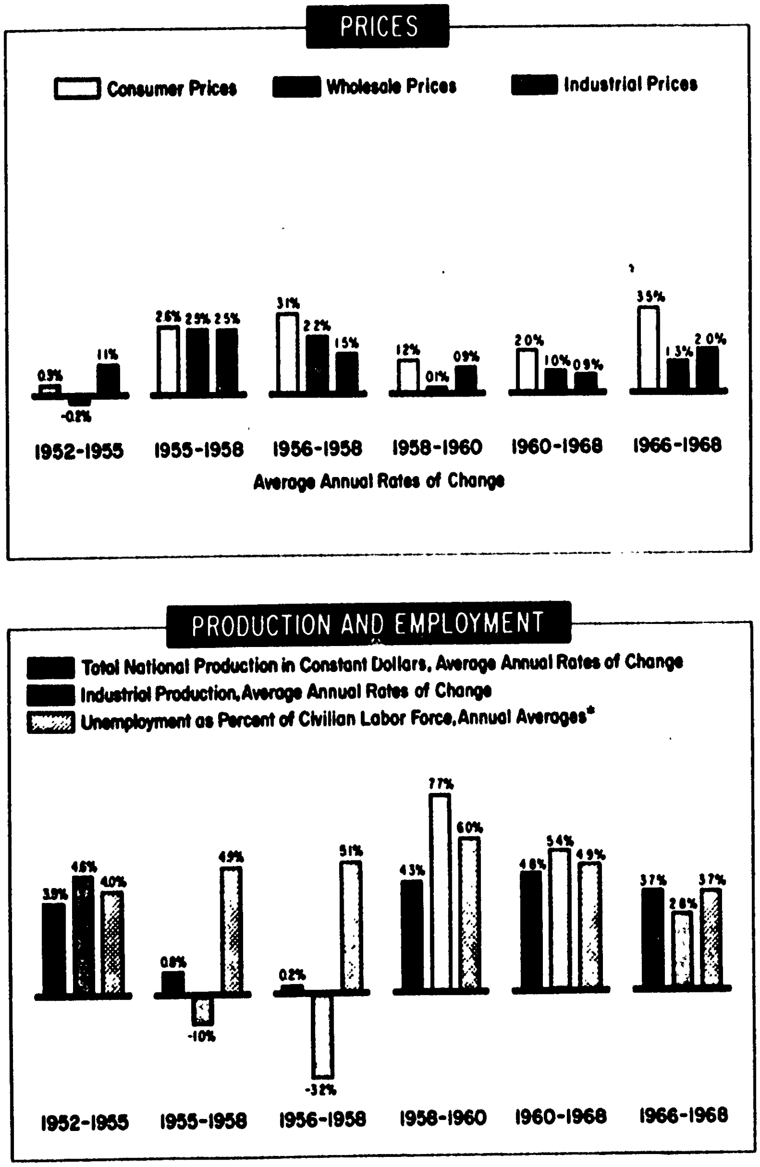


1/ Adjusted gross income class.

Source: basic data from Statement of Treasury Assistant Secretary Cohen, September 4, 1969

Chart 1A

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952-1968[1]



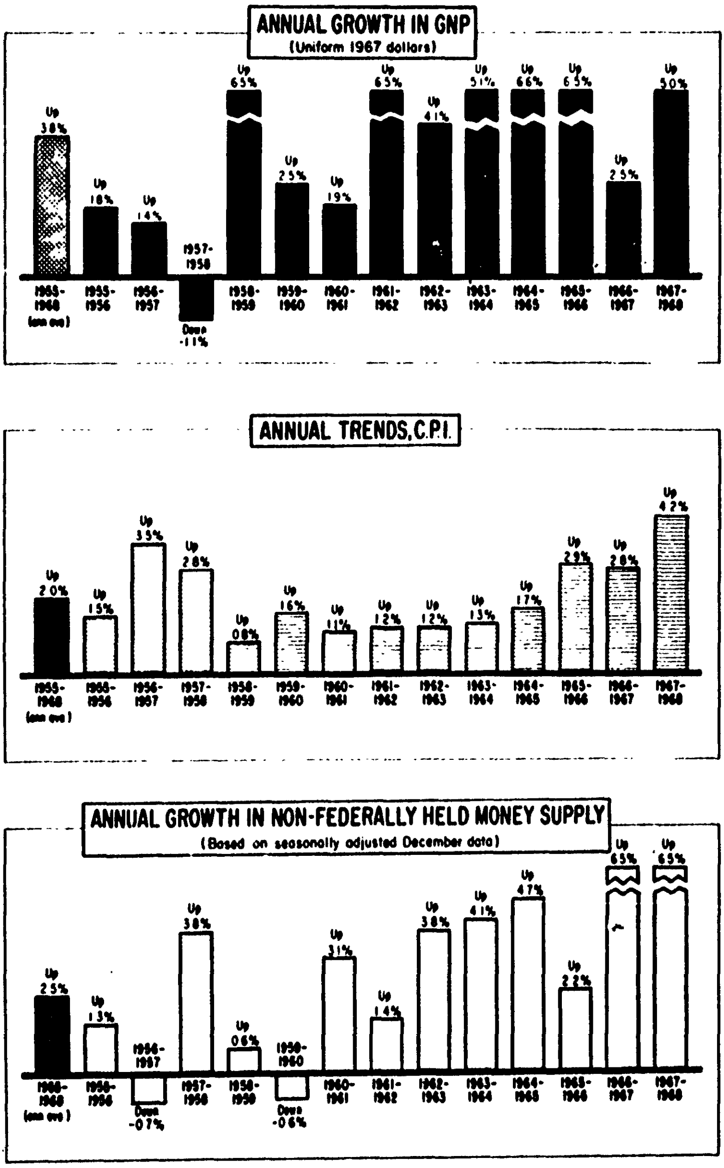
[1] Preliminary 1968 data.

*These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept of Labor, Dept. of Commerce, & Federal Reserve System.

Chart 10

COMPARATIVE TRENDS IN GNP, PRICES, AND NON-FEDERALLY HELD MONEY SUPPLY, 1955-1968[1]



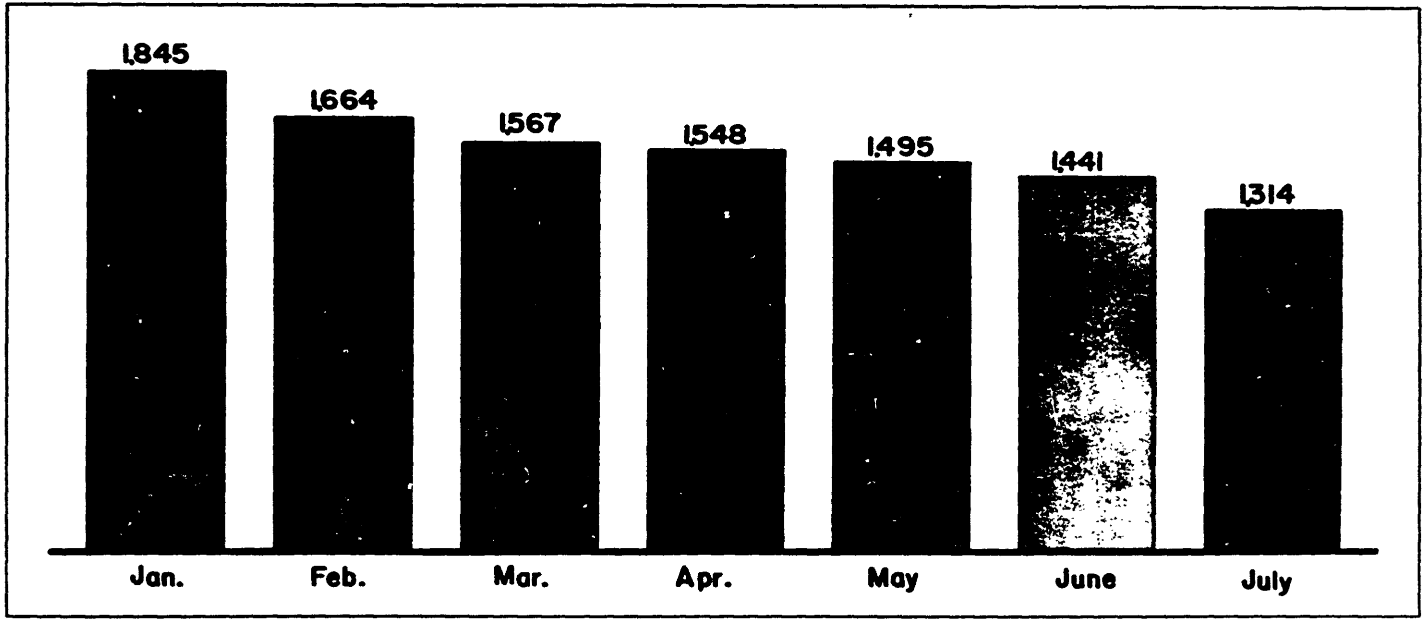
[1] All 1968 data preliminary.

Data: Economic Report of the President

Chart 20

PRIVATE NON-FARM HOUSING STARTS, 1969

(Thousands of units, seasonally adjusted at annual rates)



Source: Council of Economic Advisers, Economic Indicators

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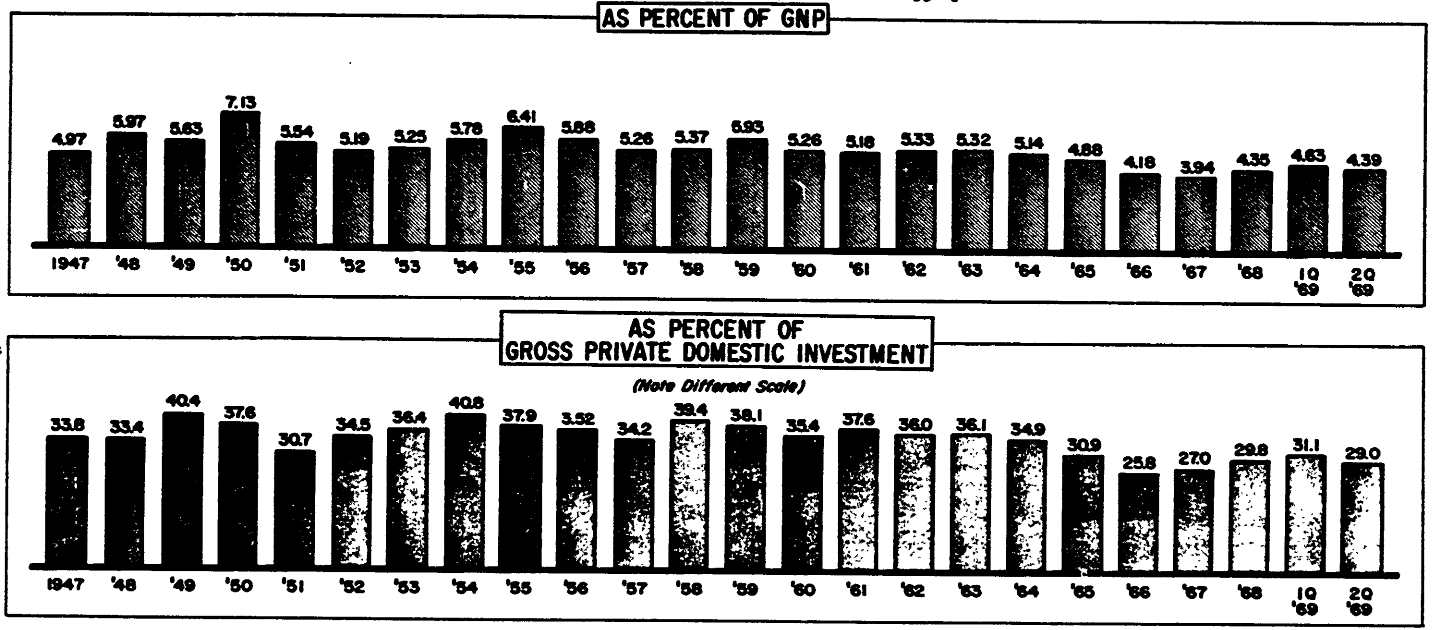
Chart 21

ROLE OF HOUSING AND COMMERCIAL CONSTRUCTION IN THE NATIONAL ECONOMY, 1947-1969

(New Construction as Percentage of Major Economic Aggregates)



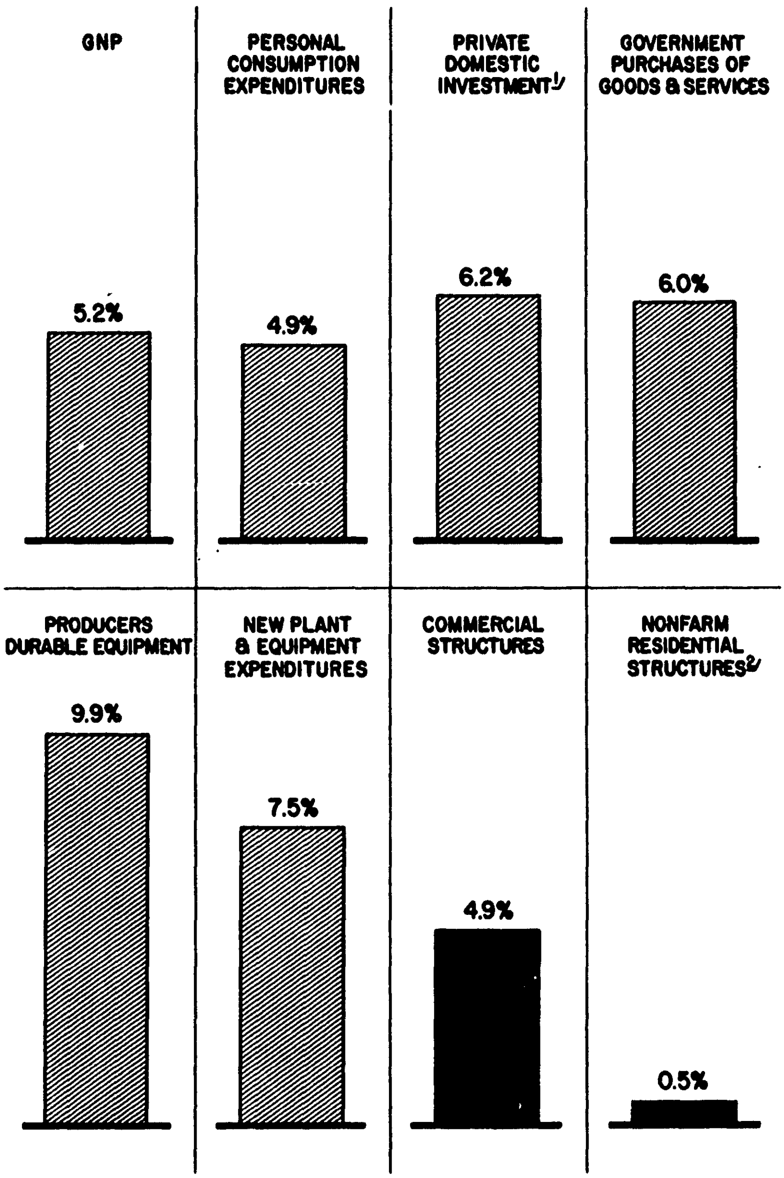
Source: Dept. of Commerce, Office of Business Economics, Survey of Current Business

Chart 22

COMPARATIVE GROWTH RATES, 1961-1968

1967 Dollars

Average Annual Rates of Change



1/ Gross private investment, including net foreign 5.0%.

2/ Total residential structures, 0.4%.

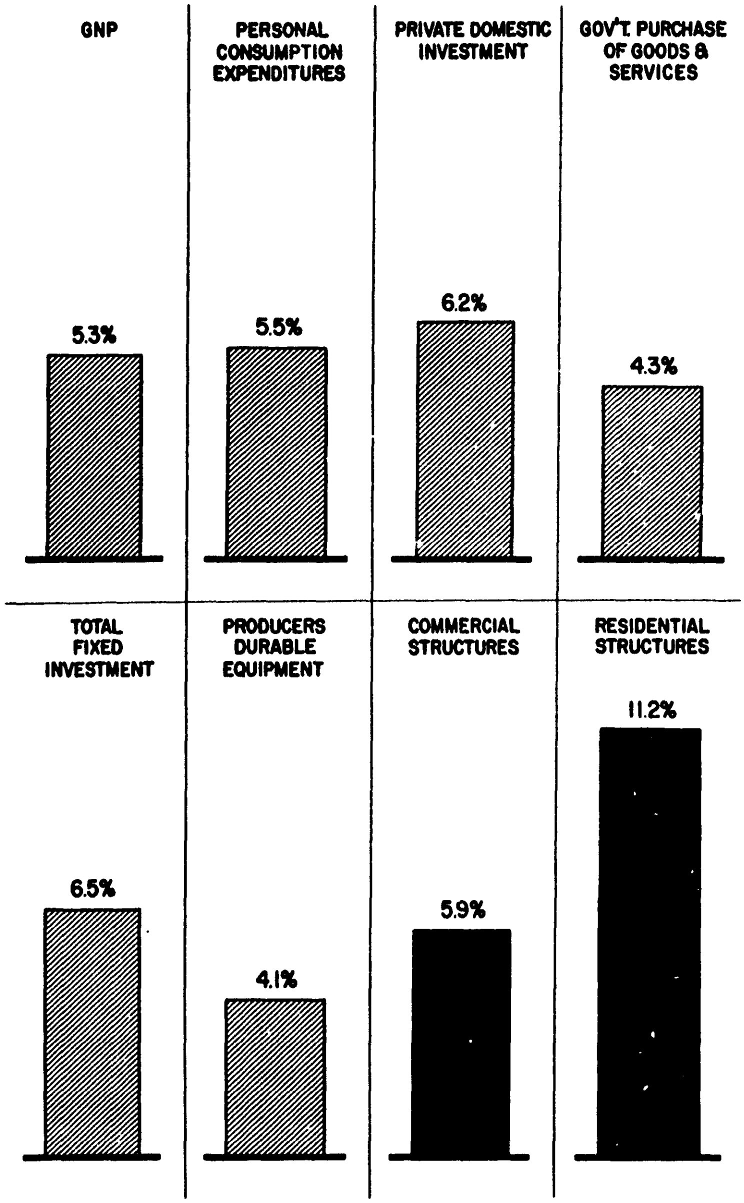
Basic Data: Dept of Commerce, Office of Business Economics

Chart 23

BALANCED GOALS FOR THE ECONOMY, 1967-1977

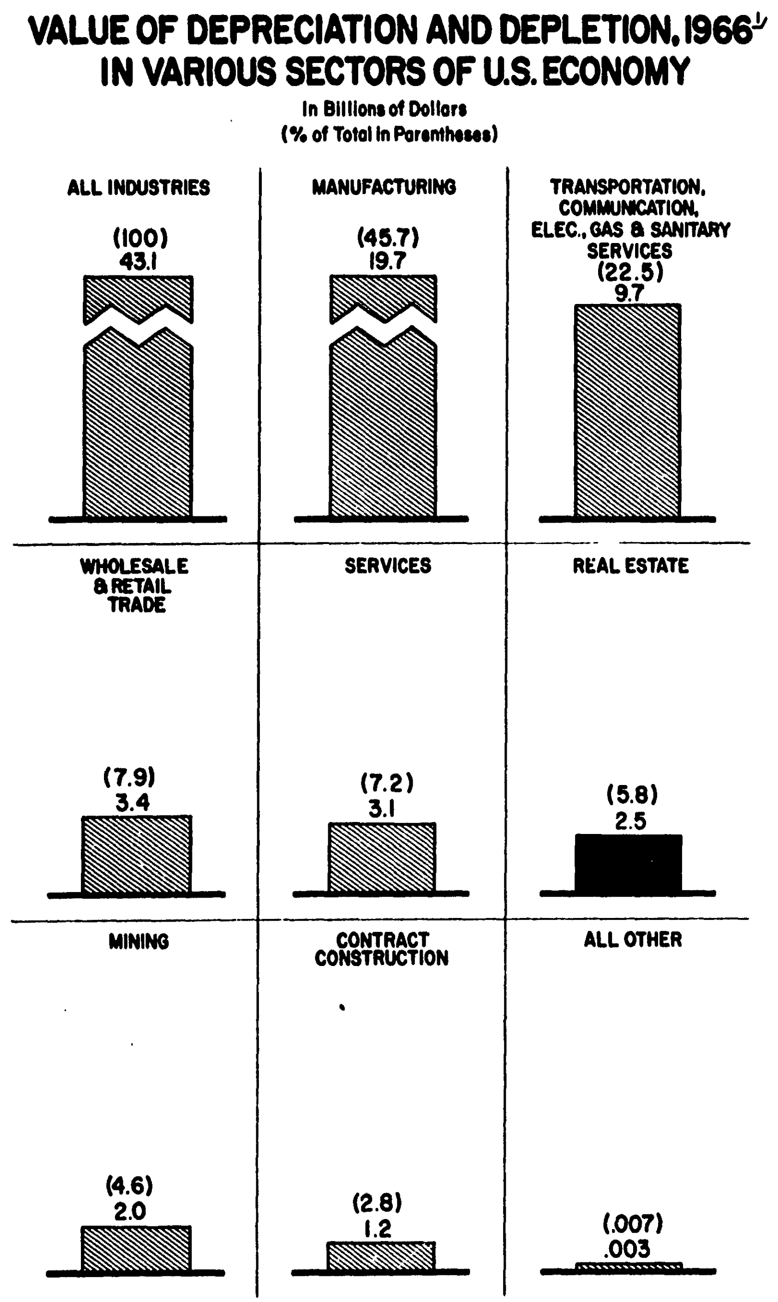
1967 Dollars

Average Annual Rates of Growth



Source: Leon H. Keyserling basically consistent with other public and private studies

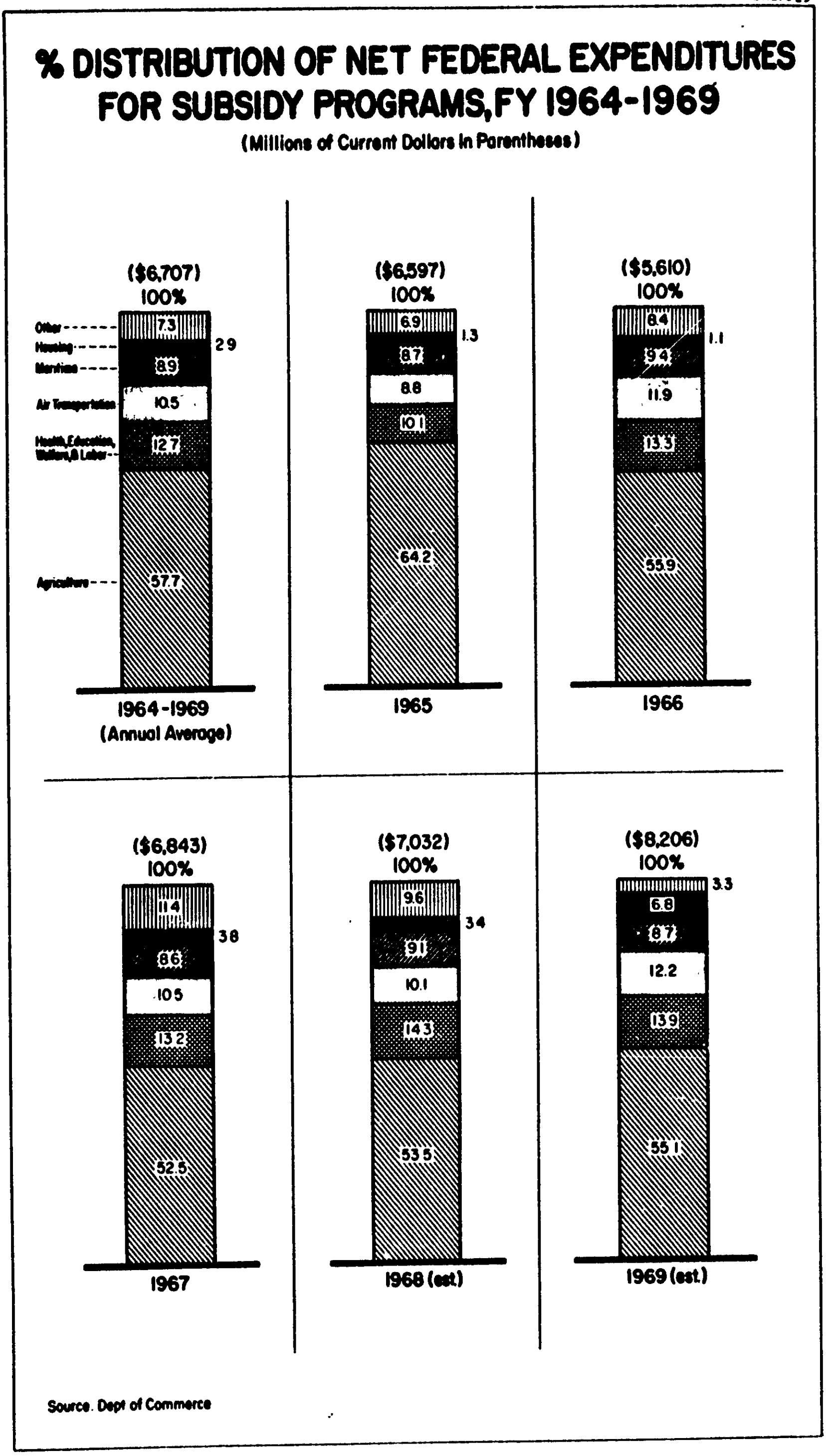
Chart 24



1/ As expressed in corporate income tax returns.

Source: Treasury Dept.

Chart 25



% DISTRIBUTION OF NET FEDERAL EXPENDITURES FOR SUBSIDY PROGRAMS, FY 1964-1969
(Millions of Current Dollars in Parentheses)
($6,707)
100%
Other
Housing
Maritime
Air Transportation
Health, Education, Welfare, & Labor
Agriculture
7.3
2.9
8.9
10.5
12.7
57.7
1964-1969
(Annual Average)
($6,597)
100%
6.9
1.3
8.7
8.8
10.1
64.2
1965
($5,610)
100%
8.4
1.1
9.4
11.9
13.3
55.9
1966
($6,843)
100%
11.4
3.8
8.6
10.5
13.2
52.5
1967
($7,032)
100%
9.6
3.4
9.1
10.1
14.3
53.5
1968 (est.)
($8,206)
100%
3.3
6.8
8.7
12.2
13.9
55.1
1969 (est.)
Source: Dept of Commerce

Chart 26

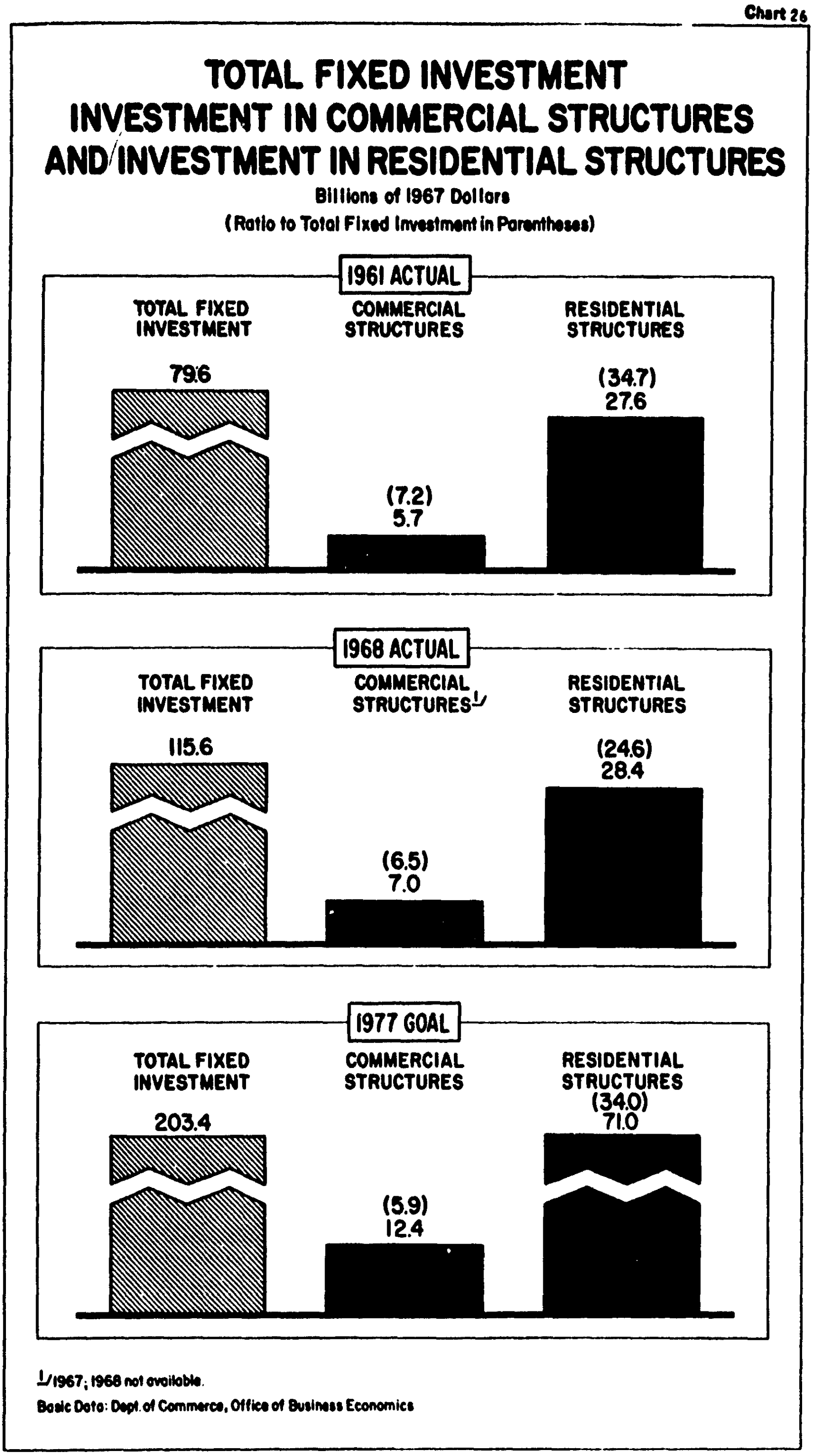
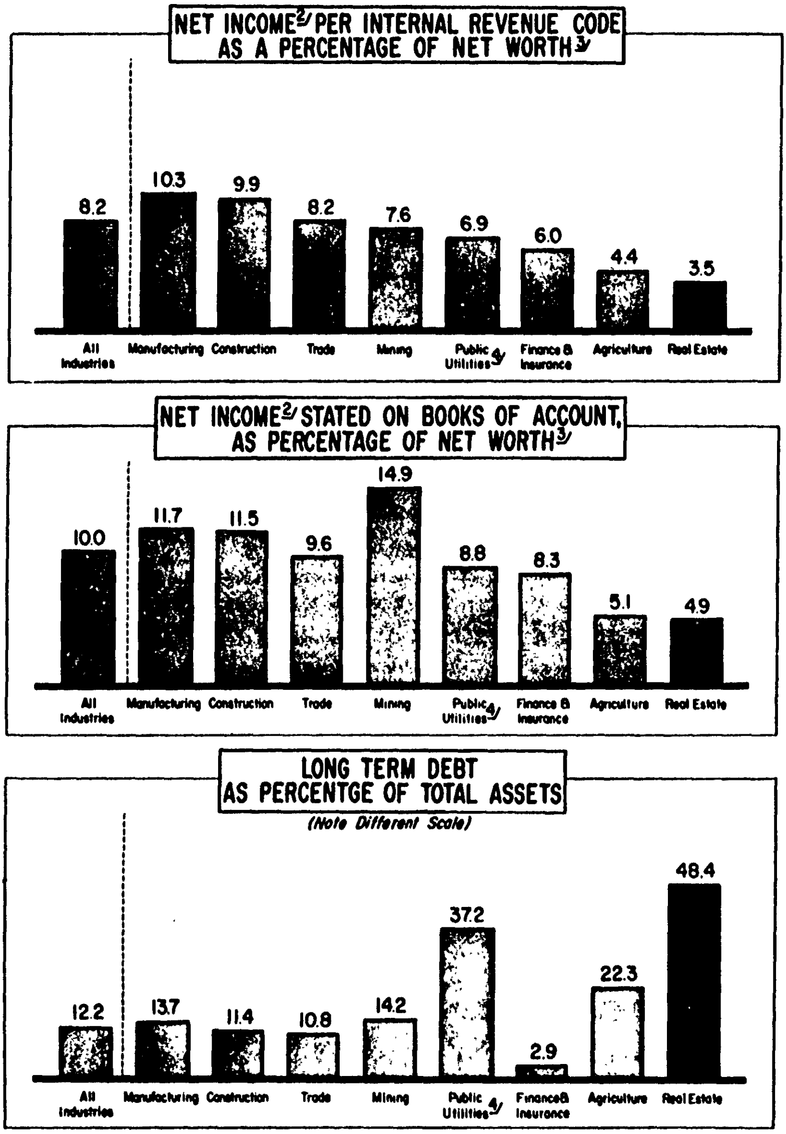

TOTAL FIXED INVESTMENT
INVESTMENT IN COMMERCIAL STRUCTURES
AND INVESTMENT IN RESIDENTIAL STRUCTURES
Billions of 1967 Dollars
(Ratio to Total Fixed Investment in Parentheses)
1961 ACTUAL
TOTAL FIXED INVESTMENT
COMMERCIAL STRUCTURES
RESIDENTIAL STRUCTURES
79.6
(7.2)
5.7
(34.7)
27.6
1968 ACTUAL
TOTAL FIXED INVESTMENT
COMMERCIAL STRUCTURES[1]
RESIDENTIAL STRUCTURES
115.6
(6.5)
7.0
(24.6)
28.4
1977 GOAL
TOTAL FIXED INVESTMENT
COMMERCIAL STRUCTURES
RESIDENTIAL STRUCTURES
203.4
(5.9)
12.4
(34.0)
71.0
1/ 1967; 1968 not available.
Basic Data: Dept. of Commerce, Office of Business Economics

Chart 27

RATES OF RETURN & OTHER FINANCIAL RATIOS ALL CORPORATIONS IN VARIOUS INDUSTRIES, 1965 1/



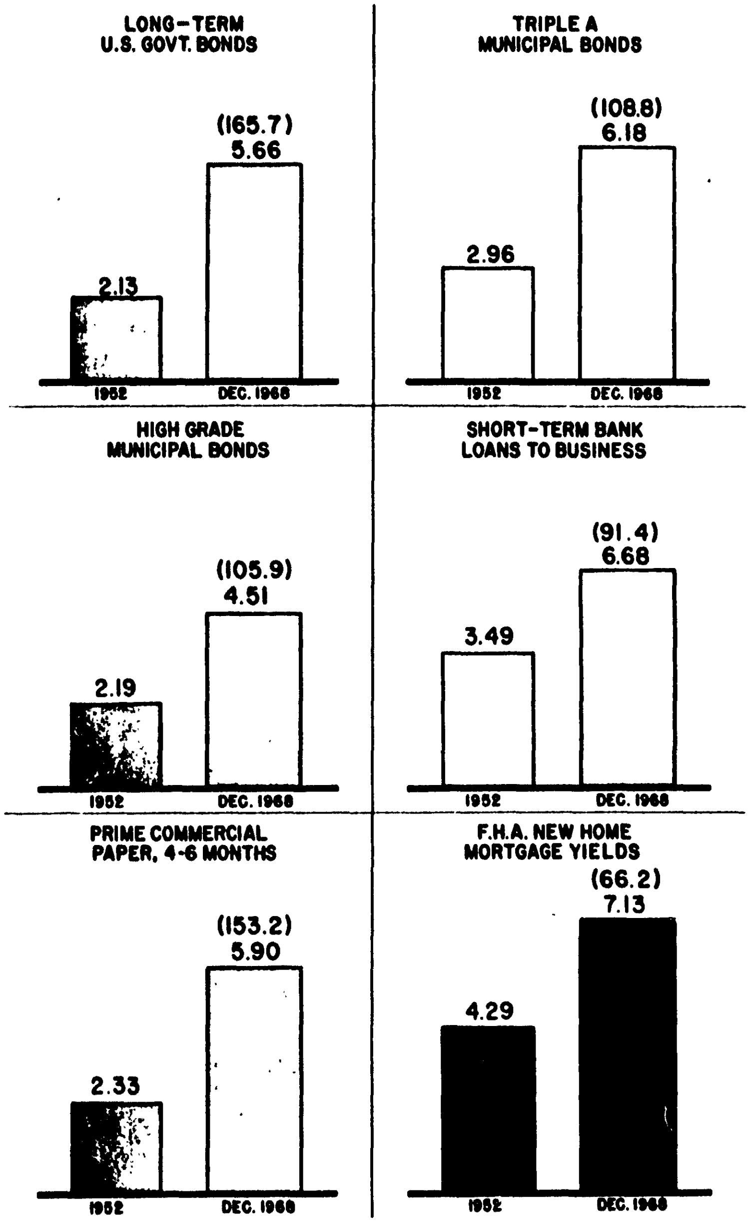
1/ Latest year available.
2/ Net income after Federal income tax.
3/ Stockholder equity.
4/ Including transportation.

Source: Treasury Dept., Internal Revenue Service, Statistics of Income, 1965 Corporation Income Tax Returns

Chart 28

BOND YIELDS & INTEREST RATES, 1952-DEC. 1968

(% Increase, 1952-Dec. 1968 in Parentheses)



Source: Treasury Dept., Federal Reserve, F H A.

APPENDIX ONE

Membership of Realty Committee On Taxation

ALBERT B. ASHFORTH & CO.
New York, N.Y.

BENENSON REALTY COMPANY
New York, N.Y.

BESSEMER SECURITIES CORPORATION
New York, N.Y.

BOISE CASCADE URBAN DEVELOPMENT CORP.
Washington, D.C.

CAROL MANAGEMENT CORP.
New York, N.Y.

CHASE MANHATTAN BANK
New York, N.Y.

CHISHOLM REALTY, INC.
New York, N.Y.

ARTHUR G. COHEN
New York, N.Y.

COLLINS, TUTTLE & CO., INC.
New York, N.Y.

THE GEORGE COMFORT CO., INC.
New York, N.Y.

CROSS & BROWN CO.
New York, N.Y.

CROWN REALTY ASSOCIATES
Chicago, Illinois

DILLINGHAM CORP.
Honolulu, Hawaii

BENJAMIN DUHL
New York, N.Y.

THE DURST ORGANIZATION
New York, N.Y.

EASTMAN DILLON UNION SECURITIES & CO., INC.
New York, N.Y.

FISHER BROTHERS MANAGEMENT CO.
New York, N.Y.

GALBREATH-RUFFIN REALTY CO., INC.
New York, N.Y.

GOLDMAN, SACHS & CO.
New York, N.Y.

GULF & WESTERN REALTY CORPORATION
New York, N.Y.

HELMSLEY-SPEAR, INC.
New York, N.Y.

HILTON HOTELS
Beverly Hills, California

IRVING TRUST COMPANY
New York, N.Y.

KIDDER PEABODY REALTY CORPORATION
New York, N.Y.

LAZARD FRERES & CO.
New York, N.Y.

LEHMAN BROTHERS
New York, N.Y.

LOEB, RHOADES & CO.
New York, N.Y.

LOEW'S THEATRES, INC.
New York, N.Y.

JOHN P. McGRATH & SOL G. ATLAS
Brooklyn, N.Y.

H.J. & M. MINSKOFF REALTY CORP.
New York, N.Y.

MORGAN GUARANTY TRUST CO. OF NEW YORK
New York, N.Y.

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RAYMOND D. NASHER COMPANY
Dallas, Texas

OESTREICHER REALTY CORP.
New York, N.Y.

PEARCE, MAYER & GREER
New York, N.Y.

ROCKEFELLER CENTER, INC.
New York, N.Y.

ROSE ASSOCIATES
New York, N.Y.

ARTHUR RUBLOFF & CO.
Chicago, Illinois

PETER SHARP & CO., INC.
New York, N.Y.

HARRY G. SILVERSTEIN & SONS
New York, N.Y.

SWIG, WEILER & ARNOW
San Francisco, California

TISHMAN REALTY & CONSTRUCTION CO., INC.
New York, N.Y.

URIS BUILDINGS CORPORATION
New York, N.Y.

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APPENDIX TWO

The Taubman-Rasche Study

Taubman and Rasche define economic depreciation as the decline in the market value of the property. They then measure depreciation from a cross section of buildings, and their analysis therefore excludes the effect of changes in the general price level: for data from any one calendar year, general inflation affects equally the rentals and expenses for buildings of all ages. Since the present discounted value (PDV) profile is calculated from this cross section, its shape (but not its height) is unaffected by the general price level. (Of course, the successive PDV profile calculated from data of different years will be different in height because of inflation.

The failure of Taubman and Rasche to consider the effect of inflation is the first major defect in their study. As I explained in the body of my testimony, the Federal tax system causes inflation to have its most adverse effect on investments with relatively long lives, such as housing and nonresidential construction. Since the Taubman-Rasche study makes no allowance for this important effect of the Federal tax system, the study is at best of severely limited usefulness in guiding tax policy.

A second objection to the Taubman-Rasche study is that PDV is calculated according to a theoretical formula, and there is no reference to the actual movements of prices for used buildings of different ages. This formula makes no allowance for risk or uncertainty, and it is not clear how the formula values relate to the actual prices of used office buildings.

On a highly technical level, there are a number of very disturbing elements in the Taubman-Rasche study. A general observation is that the authors do not present an accurate or complete description of their technique, and it is thus very difficult to offer constructive criticism -- all one can do is pose queries. Part of the problem is that I have been unable to obtain access to the authors' data in the time available, but I do feel that the authors would have added to the understanding of their study if they had made available a better description of their data base. Nonetheless, these points are in order:

(1) How does the sample of buildings change? Obviously newly built buildings are added, but are existing buildings ever removed, except when they are demolished?

(2) By looking only at existing buildings to calculate average rental rates, the authors introduce a bias. Those buildings whose rentals decline fastest should tend to be removed earliest, so that the cases where depreciation has been most rapid are not included in the sample. (Imagine taking a lifetime earnings profile by looking at a cross section of earnings by age, including only persons actually working. The effects of age discrimination in employment and retirement would be suppressed.)

(3) The PDV profile depends very much on the shape of the rental curve given by the formula

$$R^*_j = a + b(\text{age } j)^3$$

However, the authors do not tell the statistical properties of the regression fit obtained from this equation, nor do they say whether they tried any other formulas, or what kind of fit other formulas might have given.

(4) The calculation of average age within groups introduces both uncertainty and bias. The uncertainty intrudes because the population of buildings from which age is calculated is not the same as the sample (which includes only <u>some</u> office buildings). The bias occurs because the authors assume, in calculating average age, that buildings are removed only exactly at the end of 10, 25, or 40 years, or

after 60 years. In fact, the percentage of buildings still standing should decline gradually with age, and younger building cohorts in each age group should receive greater weight than older ones. Use of a flat amount of involuntary removal within each group biases the average age upward, and this understates the decline in average rentals with age. The result is to understate the rate of depreciation.

(5) To calculate removal date, the authors require estimates of land values (per square foot of office space). Whence these estimates (and what is their quality)?

(6) The authors neglect the effect of increases in building size, which causes (*ceteris paribus*) land cost per square foot of newly built office space to decrease over time. However, this effect is not present for an existing structure, whose size is fixed until the building is replaced. Failure to take account of this difference introduces an upward bias in the calculation of office building lives.

(7) The data are troublesome, especially when the rental rates for 0 to 10-year-old buildings are less than for 11 to 25-year-old buildings (1956 and 1957, in Table 3a). The authors explain that these years coincide with peak building construction and depressed rental rates for new buildings. However, this explanation is inadequate. The break in the time series is for the 11 to 25-year-old buildings (which rose in price), not for the new ones; and the operating costs (Table 3b) for the 11 to 25-year-olds also jumped in the same two years, leaving gross margins roughly constant. This suggests something else, like first appearance of 1945-1947 buildings in this group, plus shift of the 1930-1932 buildings to the next age group. If such shifts are so important, then perhaps the use of fixed age groups, with buildings moving through the groups, is questionable.

These seven points should indicate the basis of my grave doubts about the quality of the empirical work in the Taubman Rasche study. This is especially so because all of the biases identified lead Taubman and Rasche to find longer lifetimes and less rapid depreciation than is actually present. These biases, plus the two general objections stated at the beginning of this appendix, are my reasons for not accepting the analysis of Taubman and Rasche as controlling in the present situation.

Summary of Principal Points

in

Testimony of
Robert H. Pease, Vice President
The Mortgage Bankers Association of America
to
Senate Committee on Finance
on
H.R. 13270 and other tax reforms
September 26, 1969

1. The combined impact of the tax reform proposals contained in H.R. 13270 and the Treasury Department recommendations will strike a devastating blow at our construction industry by:
   a. Making less mortgage money available and
   b. Making equity investment in real estate unattractive.
2. Less mortgage money will be available because:
   a. The bill is inflationary.
      Inflation makes long-term fixed-dollar obligations unattractive except at prohibitively high interest rates.
   b. The incentives to thrift institutions to invest in mortgages are reduced.
   c. No tax is levied on the Federal Land Banks.
      The privately owned Federal Land Banks remain tax exempt driving taxpaying lenders from the agricultural loan market. This tax exemption is

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grossly inequitable and a disservice to farmers and ranchers.

3. Less equity money will be available for real estate projects because H.R. 13270 contains the following provisions which would reduce the ability to obtain a competitive profit:

   a. The use of accelerated depreciation is restricted.

   b. Available remaining excess depreciation is subjected to the Limited Tax Preference.

   c. All excess depreciation allowed would be taxed at ordinary income rates at time of sale.

   d. Capital gains rates would be increased.

   e. Hobby loss limitations are reduced and extended to apply to any enterprise with a presumption that, regardless of the nature of the enterprise, there is no expectation of realizing a profit where such losses occur in three of a five-year period.

   f. Deductions for interest on funds borrowed for a newly defined category of investment income, including rent under a net lease, would be limited.

4. In all, eight provisions of the bill, and one omission, are deterrents to realization of the urban and rural development goals the nation established in 1968.

5. Additionally, the provisions of Sec. 221 could impose a heavy tax--which was totally unforseen--on mortgage banking firms which already pay full corporate rates.

# # #

Testimony
Robert H. Pease, Vice President
Mortgage Bankers Association of America
before the
Senate Committee on Finance
September 26, 1969

Mr. Chairman, my name is Robert H. Pease. I am Senior Vice President of the Mortgage banking firm of Draper and Kramer in Chicago, Illinois and Vice President of the Mortgage Bankers Association of America. With me this morning are Mr. Graham Northup, Director of Governmental Relations for the Mortgage Bankers Association and, Mr. H. Cecil Kilpatrick, the Association's tax counsel. We appreciate this opportunity to appear before this Committee to express our views on H.R. 13270 and other proposed tax reforms. To understand our interest in this legislation, it may be well for me to speak a moment explaining who our Association represents and what our members do.

The Mortgage Bankers Association of America (MBA), now in its fifty-fifth year, consists of more than two thousand members dedicated to the originating, marketing, servicing, and holding of real estate mortgage loan investments. These mainly include:

Mortgage bankers who engage directly in the origination, financing, selling, and servicing of real estate mortgage loans for others;

Investing institutions that acquire mortgage loans from mortgage bankers, including life insurance companies, commercial banks, mutual savings banks, savings and loan associations, fire and casualty insurance companies, investment funds, pension funds, and similar institutions.

At the end of 1968, mortgage company members of the Association were servicing approximately $69 billion of mortgages. Of this, $52 billion consisted of mortgages on single-family properties, somewhat more than 20 percent of all outstanding home mortgage debt.

As originators of home mortgage loans, mortgage bankers have been major supporters of the Federal government's mortgage programs. However, mortgage bankers' interests extend into all fields of mortgage finance: residential, commercial, industrial, agricultural, and institutional. In recent years, mortgage banker members of the Association have accounted for nearly one-fourth of the net increase in the outstanding dollar amount of mortgages on apartments and other types of income-producing property.

As real estate investors we have perhaps been closer to, and therefore more concerned with, urban problems than have many others. We have lived with the developing problems, seen them grow, and seen them culminate in riots and disorders. We know only too well the vital role an adequate supply of mortgage funds can play in alleviating urban pressures and redeveloping our urban and rural areas. Through the years, Congress has sought to assure funds through direct grants as well as through a proliferation of other measures most of which failed because the magnitude of the demand exceeded available Federal resources. During 1967 and 1968 the Senate Banking and Currency Committee and a series of Presidential Commissions engaged in comprehensive reviews of previous programs. In the housing bill of 1968, new goals were established and new directions ordered for our urban development efforts. Reliance on Federal resources was minimized. The new programs sought to tap the wealth of our private sector by encouraging its maximum participation in urban investments. Because this legislation contemplated maximum results with a minimum cost to the Federal government, it was wholeheartedly welcomed by the Congress and the nation. Hope was rekindled in millions that we might now move ahead in our urban efforts unhampered by the limitations of Federal appropriations and red tape but encouraged by Federal guidance and Federal tax incentives. H.R. 13270, if enacted in its present form, will dash those hopes.

H.R. 13270 WOULD REDUCE THE AVAILABILITY OF MORTGAGE MONEY

We are concerned about the impact of H.R. 13270 on the overall availability of mortgage funds and the possible distortions that its enactment could have on the use of those funds which are available. Thus, our concern is two-fold. The proposed tax reforms may unnecessarily discourage the flow of funds for mortgages and encourage the use of these funds in other fields. They may also distort the employment of the mortgage funds remaining by over-encouraging some forms of real estate improvements, such as residential, to the detriment of well-balanced development including necessary commercial.

H.R. 13270 is Inflationary

Because as early as 1965 we recognized the threat which inflation posed to an adequate continuing flow of mortgage funds, the Mortgage Bankers Association since 1965 has urged fiscal and monetary policies to restrain inflation. We continue firm in our belief that unless inflation is controlled, there is no hope for an adequate supply of funds or any retreat from the record high interest rates which now prevail. If we can depend upon the Treasury's projections which have been made for H.R. 13270, we must conclude that its thrust is inflationary. The responsibility rests with the Congress to strike the appropriate balance between the proposed reduction of incentives for industrial investments and the proposed reductions in individual income tax, but we urge the Committee's careful reconsideration of the revenue projections and the proposed tax reductions to the end that the risk of further inflation will be eliminated.

We have attached for inclusion in the record the September issue of The Capital Goods Review of the Machinery and Allied Products Institute entitled "Effects of Inflation on Lenders and Borrowers." This article points out most dramatically the effects of taxes and inflation on the returns that are realized on fixed long-term obligations. For example, it notes that the true economic return to a lender in the 20% tax bracket on a loan made at 8% during a period when the rate of inflation equals 5% would only be 1.33%. Put another way, it shows that under the same circumstances if the lender wished to realize a true 5% return on a loan, it would be necessary to charge the borrower 12.81% of interest. Such rates on mortgages would be illegal in many states and offend the public conscience anywhere. It is obvious why mortgages are unattractive investments in periods of inflation.

Though it may be trite to say so, inflation is the cruelest tax of all. It is no service to the voter to hand him a tax reduction in one hand and take it back in inflation. If inflation is allowed to continue, mortgage funds will continue in short supply and then only at a high cost.

Incentives for Thrift Institutions to Invest in Mortgages are Reduced

Proposed tax revisions can also affect the flow of mortgage funds if they remove incentives for financial institutions to invest in mortgages. Various proposals have been offered for changes in the tax treatment of mutual savings banks, savings and loan associations and,commercial banks. Sections 441 and 442 of H.R. 13270 modify the existing provisions regarding deductions for additions to reserves and requirements respecting the percentage of assets which must be invested in residential mortgages to be eligible for such deductions. The Treasury has suggested,instead,an across the board deduction of 5% of gross interest income derived from mortgages for all banking institutions, subject to certain limitations. Mortgage Bankers pay regular corporate tax rates and are not directly affected by these proposals. However, the testimony of the affected institutions,* to whom we customarily sell mortgages, discloses that either proposal will have an adverse effect on the flow of mortgage funds at a most critical time.

The official housing goals for the next decade are well known. Less well publicised are the various studies that have been made on the outlook for mortgage funds during the next decade. These studies, made prior to any suggestions for reduced tax incentives for mortgage investment, range in their conclusions from predictions of tightness to emphatic warnings of critical shortgages. None of these studies projects a surplus of credit.

Therefore,we urge the committee to give the most serious and careful study to these proposals. Commercial banks and mutual thrift institutions were created for different purposes and continue to carry out basically different roles in our economy. It is not as important to achieve tax equality between them as to assure their continued ability, and desire, to carry out their historic functions. Reducing the incentives to invest in mortgages for institutions which have traditionally been primary sources of mortgage funds is not desirable at this time.

* National Association of Mutual Savings Banks,September 15,1969.
National League of Insured Savings Associations, September 15, 1969.
United States Savings and Loan League, September 15, 1969.
Council of Mutual Savings Institutions, September 15, 1969.
All before Senate Committee on Finance during hearings on H.R. 13270.

No Tax is Levied on the Privately Owned Federal Land Banks

In this regard the Mortgage Bankers Association urges that you enact legislation to subject the Federal Land Banks to a fair tax. Few realize that these institutions were granted complete exemption from all taxation when created in 1916 and continue to enjoy this tax-free status despite the fact that they have been wholly privately owned since 1954--and that they compete directly, forcefully, and effectively with private tax-paying lenders. Allowing the Federal Land Banks to continue wholly free from Federal, State, and local taxes is a glaring example of legislative oversight which sorely needs correction if we truly seek equity in taxation. A study of this question is attached with the request it be included for the record. We also attach a copy of H.R. 9242 as suggested legislative language to end this unfair tax exemption.

Basically we are concerned that H.R. 13270 will constrict the availability of mortgage funds because it is inflationary, because it makes mortgages less attractive as an investment for financial institutions and because, by failing to impose a fair tax on the Federal Land Banks, it drives other lenders from the Agricultural loan field.

LESS EQUITY CAPITAL WILL BE AVAILABLE FOR REAL ESTATE

The bill will also have a serious impact on our efforts to stimulate equity investment in real estate. The existing provisions of law regarding real estate depreciation and capital gains have proved to be effective incentives for equity investment in all forms of real estate development. At this point we think it matters very little that they may not have originally been enacted for this purpose. We have all heard of the tremendous tasks facing us if we are to create a suitable living environment in our nation. Creating such an environment is not solely a question of building housing--and certainly not solely a matter of low-and moderate-income housing. There must also be factories, warehouses, stores, churches, schools, gas stations, highways, sewer and water systems and all of the other improvements and services which go to make up the living environment. This will require tremendous investments of savings, and unless those investments can be generated from the private sector, the burden will fall increasingly on government. Despite any impressions to the contrary, real estate ventures involve a high element of risk. Many go broke. Very clearly, private capital will be drawn into investments which provide the largest after tax profits. Existing tax incentives are essential to continue to draw private capital into housing and commercial properties.

How, you may ask, would a project sponsor obtain what he considers an adequate profit in the absence of tax incentives? The only answer we know is that he would have to increase the direct return from the project by increased charges to the occupant or occupants. But look at what has happened, for instance, in the urban apartment market. Land costs have skyrocketed. Materials, labor, mortgage money and all the other components of construction have climbed sharply. The result is that even with the present tax incentives, it is virtually impossible to construct new apartments that low income familes can afford. In many of the higher cost areas you cannot build for the middle income people--which means people earning up to $10,000.

Let me give you an example. About four years ago our firm built an apartment building with monthly rents that averaged approximately $53 per room. We owned some additional land adjoining this project and we recently considered building another building adjacent to the existing apartment project. As we already owned the land, the increase in land value did not really affect our decision. We figured current construction costs of the new building, ascertained our new interest cost and gave up the project. We would have had to rent the new building for $75 per room. We felt this was too risky. Even with accelerated depreciation, we were unwilling to build the apartment.

If existing tax incentives were removed, it would be necessary to increase rents even further, which would inevitably result in construction being undertaken only for the most affluent. Lacking a demand from affluent tenants, no construction would be done and available capital would flow to other fields.

Income properties erected for business occupancy contain an even higher element of risk. Particularly is this true of those designed to serve the small businessman. Neighborhood merchants, the "mama and papa" stores, throughout the nation have long protested that urban renewal is putting them out of business because they cannot afford the rents in the new space made available after old stores are torn down. Without tax incentives their rents would be even higher.

H.R. 13270 would allow accelerated depreciation only for new residential structures. Under this condition equity capital for business structures would be non-existent, except of course for the larger more credit-worthy corporation.

We do not concur with the administration position, as expressed by Assistant Secretary Cohen in his appearance before you on September 4th (Sec. 25),that the proposed changes in real estate depreciation and capital gains are either appropriate or are consistent with the achievement of our housing goals; nor are we "concerned with the continued heavy reliance upon tax incentives" as a means of achieving those goals. May we remind this Committee that for several years the housing and home finance industries, the Department of Housing and Urban Development, and the Congress itself have concerned themselves with questions about tax incentives to further stimulate urban development. Any number of bills are introduced each year proposing new incentives. In 1967 the Senate Banking and Currency Committee asked us informally for suggestions for any needed new incentives. Other Senate committees have held hearings on bills for this purpose, specifically those introduced by the late Senator Robert Kennedy. After much study, it was concluded that existing incentives would suffice if a broader range of investors were encouraged to use them. Consequently, Congress passed a bill last year authorizing the creation of a National Corporation for Housing Partnerships to spread the word and attract new investors. Notwithstanding the Treasury's concern, the Congress has acted--it wants these tax incentives utilized.

Limited Tax Preference

Why then do we now seek to eliminate most tax incentives and reduce the others? The answer is,very simply, because a smokescreen of 154 wealthy non-taxpaying citizens has been thrown up to cloud the voters' view of this picture. Surely, these wealthy people should pay a fair share of taxes. The Limited Tax Preference, which we strongly support, would assure that they would. Limited Tax Preference as originally proposed--that is, including income other than that sheltered by depreciation--should be enacted. To do so would be fair and equitable.

These 154 people represent only one percent of the taxpayers in the $200,000 and over tax bracket, and we should not eliminate badly needed tax incentives in a hasty effort to respond to public indignation about them.

The Administration urges enactment of some of these proposed reforms in order to maintain the level of Federal revenue for some future unspecified plan of Federal Revenue Sharing. We submit that the present incentives are an effective means of accomplishing that objective. For example, assume we create a property valued at $1,250,000. Further assume the land is worth $250,000 so the depreciable improvements are valued at $1,000,000. Using the double declining balance method, first year depreciation would be $40,000. This means the U. S. Treasury would lose $20,000 of revenue that it might have received if depreciation is limited to straight line. We say "might have received" because it is our experience that many of these projects would not be built without the present tax incentives. Tax authorities tell us that local real estate taxes average 2% of value, which means this project would generate $25,000 of income for the local community the first year. Further, the Federal revenue loss would diminish each year while the local revenue would probably increase, or at worst remain stable. In other words, the Federal tax incentives for real estate investment directly benefit local communities in an amount which exceeds the Federal revenue loss. This revenue sharing plan is in operation now.

Let me cite a few examples of how this has worked in my home town of Chicago.

Ten years ago, the area from 31st to 28th Street and South Parkway in Chicago was one of the worst sections of the city. Few if any taxes were being paid. Most of the buildings were in virtual shambles. It was one of the worst slums in the city. Today this area is one of the fine residential sections of the city with a waiting list for apartments in each of the five multi-story buildings that were built there. This is the site of a project known as Prairie Shores. There are 1700 apartments; the occupancy is 80 percent white, 20 percent non-white and we have not had a vacancy for as long as I can remember. When this project was built, the risks connected with it were very great, and it was extremely difficult to induce people to put equity into the deal. I can assure you that one brick would never have been laid on another without accelerated depreciation.

The benefits to the city of Chicago from this project are almost incalculable. Michael Reese Hospital, which is one of the city's finest institutions, was considering moving; they have stayed. Virtually no real estate taxes were being paid on the property. In the last 10 years, regular tax bills have been paid. The entire area has been completely transformed into a community with new housing and new values.

Just a few blocks south of Prairie Shores is the development known as South Commons. It is located in and around 29th Street and Michigan Avenue. It is composed of low-and moderate-income housing projects insured under sections 220 and 221(d)(3) of the National Housing Act. The total investment in this project will be approximately $20 million. Parts of it have already been built, and construction is proceeding on the balance. I talked with the firm of Baird and Warner, which is the managing partner for the group that runs this development. They said that it would never have been built without accelerated depreciation nor would it have been built without Prairie Shores which was in turn built because of accelerated depreciation.

Sandburg Village is a relocation housing project built under Section 220 of the National Housing Act containing approximately 2600 apartments at North Avenue and LaSalle Street in an urban renewal area of Chicago. This project was developed by Dovenmuehle, Inc. I talked to Mr. Buenger, the President, and he told me that without accelerated depreciation this project would never have been started nor the subsequent addition made. Again, this type of development has changed the entire community. It has brought real estate taxes to the municipality both from the specific project and from the other improvements that have been made because of the change in the neighborhood.

We are most anxious to impress upon you the fact that benefits of accelerated depreciation are very large both to a community and to the general real estate market. These benefits are difficult to measure in dollars, but they are sizeable. I have cited to you three specific examples of areas in Chicago which benefited from real estate development made possible because of accelerated depreciation. The changes brought about by the investment in these projects have completely reversed the real estate market that existed in these areas. Equally important, they have completely reversed the real estate tax base, which was almost totally zero, and have made these areas major real estate taxpayers. The building of these projects has brought other investments into the community, and these in turn have further added their benefits to the areas. We strongly urge you to think of accelerated depreciation as a vehicle for the upgrading of our communities, the building of billions of dollars of new real estate improvements, and the creation of values in our country which are indispensable both for housing people and for buttressing our ecomony.

CAPITAL GAINS

It is important to understand that accelerated depreciation and capital gains treatment must be viewed as one when discussing incentives for real estate investment. Allowing excess depreciation but recapturing all excess depreciation at ordinary income tax levels at time of sale merely delays the tax. The incentive is not in delaying the tax but in increasing the likelihood of return of the investment. If the investment is to be meaningful, there must be an opportunity to retain the gain. Under Section 521 of H.R. 13270 the present recapture formula (Sec.1250) would be eliminated. We urge this not be done. We do, however, concur that a modification providing for full recapture of the excess in the event of a sale during the first five years with 1% allowed for each month the property is held thereafter would be acceptable. This would permit the investor who holds a property 13 years and 4 months before selling to pay only the capital gains rate on the amount received over the depreciation value.

Surely, if Limited Tax Preference is enacted and the capital gains recapture formula recast in this fashion, accelerated real estate depreciation can no longer be abused to escape the payment of income tax. Additionally, H. R. 13270 proposes an increase in the capital gains rate.

Section 213 Hobby Losses

Section 213 of H.R. 13270 broadens the so called "Hobby Loss" provisions by deleting the reference to "individuals" and substituting "taxpayers." Thus, it seems that Section 270 would henceforth apply to corporations. Furthermore, Section 270 has been broadened in its application so that it would now appear to include real estate transactions. While this may never have been intended, it could have serious repercussions in the real estate field, and we urge that it be amended so that it will not apply.

Under a number of the Federal Housing Administration's multi-family housing programs, maximum loans can be as high as $12,500,000. Obviously multimillion dollar projects are a long time in the construction period, two years is not unusual, and it ordinarily takes from 12 to 24 additional months to reach a break-even occupancy level. In other words, there can be three or four years of heavy losses in every large project even though no excess depreciation is used. If Section 213 of H.R. 13270 is enacted, it would mean that every project sponsor would face the task of negotiating with the Internal Revenue Service to overcome the presumption that there had been no expectation of realizing a profit. To create such an impediment to investment is totally unreasonable.

Section 221

Section 221 of H.R. 13270 would limit interest deductions for funds borrowed for investment purposes. It would also broaden the present definition of investment income to include certain forms of rental income.

This represents still another deterrent to investment in real estate and would be particularly harmful to those forms of real estate such as shopping centers customarily occupied on a net lease arrangement. In its present form we consider this Section vague and ambiguous. Assistant Secretary Cohen has stated in his testimony that it fails to correct the problem to which it was addressed and has recommended against its enactment. We concur in his view, for this provision would cause serious disruptions for mortgage bankers on two counts.

Mortgage lenders selling loans to the Federal National Mortgage Association (FNMA) are required to purchase FNMA stock in a specified amount for each loan delivered. In order to retain the servicing on these loans (for which a servicing fee is paid) the seller is prohibited from selling this stock. The stock is therefore effectively restricted. Mortgage bankers sell large quantities of home loans to FNMA. So much in fact, that many find a very high percentage of their capital and surplus tied up in this stock and, to obtain working capital, have had to borrow funds pledging the stock as security. It is clear enough to us that such borrowings are for business purposes--for our business is making and servicing loans--but we find the language of H.R. 13270 far from clear in its definition of the difference between "investment" and "business" purposes. At least one recent court decision (Leslie, et al v. Commissioner, CCA-2, 69-2 USTC P 9540) further clouds the distinction. Should Section 221 be enacted, it seems clear that our presently allowable interest deductions would be challenged--and very likely denied. We foresee years of litigation before a clear decision is reached.

We are certain that this result was not contemplated when the language of Section 221 was drafted. Mortgage bankers have never to our knowledge been accused by anyone of paying less than their fair share of taxes. The stockholding requirement was authorized by the Congress to expedite the rapid transition of FNMA from Federal to private ownership. To deny the industry the deduction of interest on funds borrowed to offset the burden of holding this stock is not only grossly unfair but would serve effectively to thwart Congress' own expressed desires.

We oppose the enactment of Section 221 not only because of the impact on our business but because:

1. It would seriously impede the needed construction of shopping centers and other business structures under normal and customary financing arrangements. (It should be noted that construction may take a year or more. Section 221 is not clear but is subject to the construction that all interest paid or accrued during that period would be disallowed as a deduction.)

2. It is based on a completely fallacious assumption that the purpose of the borrowing is to acquire property to be sold at capital gains rates later, rather than to produce rental income.

3. To equate the case of one who borrows money to buy low yield stocks, and who therefore is a purely passive investor, with one who borrows to buy or build rental property which will bring in a good yield to justify the investment, is unsound. Therefore we urge that Section 221 not be enacted.

Conclusion

We hope to make one point above all others perfectly clear. The combined impact of the tax reform proposals contained in H.R. 13270 and the Treasury Department recommendations will strike a devastating blow at our construction industry. We are absolutely convinced that the House of Representatives was not aware of all the implications of the various individual proposals in H.R. 13270 and had very little understanding of the effect which they would have on real estate investment when considered in their totality. May we just review these in closing?

A. Mortgage funds will be less plentiful because:

1. The legislation is inflationary
2. Savings and thrift institutions' incentives to invest in mortgages are diminished.
3. The privately owned Federal Land Banks remain wholly tax exempt, driving tax paying lenders from competing for agricultural loans. This tax exemption is grossly inequitable and a disservice to farmers and ranchers.

B. Equity capital is discouraged from the real estate field because:

1. Excess depreciation is denied or reduced.
2. Available remaining excess depreciation is subjected to Limited Tax Preference.
3. All excess depreciation allowed would be taxed at ordinary income rates at time of sale.
4. Capital gains rates would be increased.
5. Hobby loss limitations are reduced and extended to apply to any enterprise with a presumption that, regardless of the nature of the enterprise, there is no expectation of realizing a profit where such losses occur in three years of a five year period. Deductions for interest on funds borrowed for a more broadly defined category of investment income would be limited.

We urge the Committee to consider the combined impact of these various proposals on real estate investment. Although it is right and proper for all citizens to pay a fair share of tax, we should not forget, under the pressure of public indignation over the few who have avoided income taxation, that this nation has developed to its position of world leadership because of a strong and vibrant economy solidly based on the profit motive. The very citizens who are momentarily indignant enjoy the highest standard of living in the world because we have encouraged venture capital. To solve our major domestic problems we must continue to encourage massive investments in real estate development over the next decade.

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Capital Goods Review

MACHINERY and ALLIED PRODUCTS INSTITUTE

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EFFECTS OF INFLATION ON LENDERS AND BORROWERS

There has been a good deal of comment of late about "astronomical" interest rates. While it has been generally recognized that they are in part a response to the prevailing inflationary anticipations (borrowing is made more attractive by the prospect of repayment in cheaper dollars, lending less attractive by the prospect of receiving such dollars), there has been too little discussion of the degree to which they actually reflect and conform to these anticipations. Will the present level of rates maintain *real* lender returns and borrower costs at the level that would obtain without inflation?

This question is obviously unanswerable as stated, since it turns on an unknown: the amount of inflation anticipated. No doubt this varies widely from one forecaster to another, but the real question is how much is being discounted by the *market*. This would have to be inferred from the difference between the present interest-rate level and the one that *would* obtain in the absence of inflationary expectations. Since the latter is indeterminate (history does not disclose alternatives), the inference would be dubious, if not entirely useless.

It is possible, however, to explore the impact of inflation on lender returns and borrower costs by means of hypothetical cases, and to draw some inferences for the present situation. This we propose to do. We shall first work through a simple, round-number example and then give the results for a reasonable range of assumptions.

Example

Suppose a loan of $1,000 with interest at 10 percent payable annually is made by an investor in the 40-percent income-tax bracket. Suppose further that the inflation rate is 5 percent per annum. At the end of the year, he harvests $100 in interest, of which the Treasury takes $40, leaving $60 after tax. In view of the 5-percent inflation rate, however, it requires $1,050 at the end of the year to equal in real terms the $1,000 invested at the beginning. This means that he has to reinvest $50 of his after-tax interest receipts to maintain the integrity of his principal, leaving only $10 of real income. But even this is in year-end dollars, which are smaller than the dollars of investment. In terms of the latter, he has $9.52, and a true rate of return of 0.95 percent. This from a lending rate of 10 percent![1]

Now look at the same transaction from the side of the borrower. Having borrowed the equivalent of 1,050 year-end dollars, but owing only $1,000, he has in effect had a reduction of real indebtedness by 50 such dollars, and a transfer to equity of that amount. Subtracting this gain from the $100 year-end interest payment, he has a net cost of $50, equivalent to $47.62 in the dollars borrowed, a rate, therefore, of 4.76 percent.

Tax Aspects

The spread between the real *return* to the lender after allowance for the erosion of principal from inflation (0.95 percent) and the real *cost* to the borrower after allowance for the gain to equity from the same cause (4.76 percent) is due, of course, to the difference in the tax treatment of the two sides. Interest receipts are taxable, interest payments deductible.[2] For a *nontaxable* lender, the return would equal the borrower's cost.

[1] The result is independent of the duration of the loan, as may be confirmed by converting the lifetime flow of after-tax receipts into the dollars of investment and solving for the implicit return.

[2] Because of their deductibility, the borrower's cost is independent of his tax status. See "The Cost of Borrowed Capital," *Review* No. 78, June 1969.

There is an obvious anomaly here in the treatment of inflation effects. The $50 that the lender must set aside at year-end to offset the *loss* of his real principal is taxed as income. On the other hand, the $50 *gain* to equity from the reduction of the borrower's real liability is untaxed (deductible as a cost). Clearly this is topsy-turvy. The loser pays and the gainer gets off free.

If the burden were reversed, the lender being granted deductibility for his capital loss and the borrower taxed on his gain, the picture would be rather different. Assuming, for example, a 40-percent tax rate on both sides, the lender's real return would be 2.86 percent instead of 0.95.[3] The borrower's real cost, on the other hand, would be 6.67 percent against 4.76.[4] But since the effect of inflation is ignored for tax purposes, this calculation is of course purely academic.

Lender's Real Return Over a Range of Cases

The foregoing example assumes a single inflation rate, a single interest rate, and a single tax rate. Similar calculations for a range of rates are shown below.

Lender's Real Returns for Various Inflation, Lending, and Tax Rates[a]

Tax Rate (Percent)	Inflation Rate: 3 Percent, Lending Rate (Percent) 6	8	10	Inflation Rate: 5 Percent, Lending Rate (Percent) 6	8	10
0	2.91	4.85	6.80	0.95	2.86	4.76
20	1.75	3.30	4.85	−0.19	1.33	2.86
30	1.17	2.52	3.88	−0.76	0.57	1.90
40	0.58	1.75	2.91	−1.33	−0.19	0.95
50	0.00	0.97	1.94	−1.90	−0.95	0.00
60	−0.58	0.19	0.97	−2.48	−1.71	−0.95
70	−1.17	−0.58	0.00	−3.05	−2.48	−1.90

[a]Assumes interest paid annually.

A quick glance at this table suffices to show the effect of even moderate inflation rates on the real returns of lenders subject to income tax. With a 3-percent inflation, a lender in the 30-percent tax bracket gets a real after-tax return of only 3.88 percent from a 10-percent loan rate. With a 5-percent inflation, he gets 1.90 percent. If his tax bracket is 50 percent, his returns are 1.94 percent and zero, respectively. The double tax-and-inflation bite is obviously devastating.

It may be interesting to show these results in a different form. Instead of solving for the real after-tax returns from various combinations of factors, suppose we solve for the lending rates required to yield specified returns. These appear in the next table.

Lending Rates Required To Yield Specified Real After-Tax Returns With Various Inflation and Tax Rates[a]

Tax Rate (Percent)	Inflation Rate: 3 Percent, Required Real Return (Percent) 3	4	5	Inflation Rate: 5 Percent, Required Real Return (Percent) 3	4	5
0	6.09	7.12	8.15	8.15	9.20	10.25
20	7.61	8.90	10.19	10.19	11.50	12.81
30	8.70	10.17	11.64	11.64	13.14	14.64
40	10.15	11.87	13.58	13.58	15.33	17.08
50	12.18	14.24	16.30	16.30	18.40	20.50
60	15.23	17.80	20.38	20.38	23.00	25.63
70	20.30	23.73	27.17	27.17	30.67	34.17

[a]Assumes interest paid annually.

Here the picture is, if anything, even more striking. To get a real after-tax return of 5 percent, a lender in the 30-percent tax bracket needs a loan rate of 11.64 percent with a 3-percent inflation and 14.64 percent with a 5-percent inflation. If his tax bracket is 50 percent, he needs 16.30 and 20.50, respectively. Even for a real return of only 3 percent, he needs loan rates of 8.70 and 11.64 percent if he is in the 30-percent tax bracket and 12.18 and 16.30 percent if he is in the 50-percent bracket.

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[3] The lender's tax would be $20, leaving $80 after tax. Subtracting $50 for capital erosion, we have $30 (year-end), equivalent to $28.6 in the dollars of investment.

[4] With $50 of the borrower's interest payment taxable, he would pay $120 (100 to the lender, 20 to the Treasury). Subtraction of the $50 capital gain leaves $70 (year-end), of which the investment-dollar equivalent is $66.7.

Cost to Borrower

As indicated earlier, the real cost of debt to the borrower is reduced by the shrinkage of his obligation through inflation. It is the *excess* of the interest payment over this shrinkage.

Since interest cost is deductible, hence independent of the borrower's tax rate, this eliminates one of the variables that must be taken account of on the lender's side, leaving only the inflation and lending rates. If we assume the same values for these rates as before, we get the following:

Borrower's Real Costs for Various Inflation and Lending Rates

Lending Rate (Percent)	Inflation Rate	
	3 Percent	5 Percent
6	2.92	0.95
8	4.86	2.86
10	6.80	4.76

As we indicated earlier, the reduction of the borrower's real cost by inflation is less drastic than the reduction of the lender's real return. Thus, for example, a 5-percent inflation reduces the cost of a 10-percent loan to 4.76 percent, while reducing the real after-tax return to 1.90 percent for a lender in the 30-percent tax bracket and to zero for one in the 50-percent bracket.

The Present Situation

If we take the present inflation rate as 5 percent (recent figures make it even higher), it is evident that current lending rates leave most creditors with net losses in real terms. An 8-percent bond returns less than nothing net to a taxpayer in the 40-percent bracket, as does a 6-percent savings and loan account to one in the 20-percent band. A first-bracket (14-percent) taxpayer is substantially in the red on a 5-percent certificate of deposit; so too, of course, is a nontaxable lender on a 4-percent passbook account.

The Department of Commerce reports "total net public and private debt" of $1,569 billion at the end of 1968. At a 5-percent inflation rate, the shrinkage in the real value of this body of obligations is nearly $80 billion a year. When we consider that the bulk of them bear interest rates well below the current level, this annual erosion is almost certainly in excess of the collective after-tax interest yield to the ultimate beneficiaries (the individuals who benefit either directly or as claimants against financial intermediaries).

It is evident from our earlier table on lending rates required to yield specified real after-tax returns that with a 5-percent inflation and present tax rates there is little possibility of getting a significant real return even from the "astronomical" interest rates now prevailing on new loans. Even if the inflation rate were cut to 3 percent, a modest return would still require higher-than-present rate levels for most lenders and institutional creditors.

Here is the "euthanasia of the rentier" with a vengeance. The stagnationists who espoused this phrase were thinking of a *decline* of interest rates toward zero; the euthanasia now in process is occurring at the highest levels in memory. Inflation is accomplishing what "economic maturity" never did.

The question naturally arises why individuals persist in lending funds either directly or to financial intermediaries at rates that yield negative real after-tax returns. The answer is complex. Many do not fully realize the extent to which their capital is being eroded. Others who understand are at a loss to know what to do about it. Smaller savers particularly are accustomed to accumulate capital in dollar form—life insurance, time deposits, savings and loan shares, savings bonds, etc. While they may acquire a house and consumer durables for their own use, or invest in their own business, impersonal inflation hedges such as common stocks and income real estate are often outside their experience, and even when not are likely to be unsuitable to the purpose for which the dollar assets are held. Whatever the reasons—ignorance, habit, convenience, security—attachment to such assets is not easily dislodged.

It is an interesting speculation how a long-continued inflation at the present rate would affect this behavior pattern. What would it do to the structure of the capital market? How would it affect financial intermediaries? To what extent would creditor-protection devices be applied, such as price-level escalation, equity participation, etc.? These and similar questions are easier to ask than to answer. In any case they are beyond the scope of this essay. It is to be hoped, certainly, that inflation will be brought under control before they are answered by events.

Mortgage Bankers Association
of America
July 31, 1969

THE FEDERAL LAND BANK SYSTEM AND TAX EXEMPTION

When the Federal Land Bank System was created in 1916, it was granted exemption from all taxation. At that time the composition of the agricultural economy and the character of the financial institutions which served it were vastly different from what they are today. In the fifty-three years since, these conditions have changed, but, to the best of our ability to determine it, the appropriateness of the tax exemption has never been reconsidered. We believe the exemption should be repealed.

Changes in the Agricultural Economy

The total number of farms in the United States has been declining, almost without interruption, since the time the Federal Land Bank System was created. According to the 1920 Census, there were over 6.5 million farms in the country with an average size of 148 acres. By 1940, this number had declined to about 6.4 million, and between that year and 1959, it dropped nearly 36 per cent to 4.1 million, while average acreage rose from 167 to 288. In the ten years since then, the number of farms has slipped to about 3.0 million and the average acreage has risen to about 380. 1/

Although the amount of cropland has been declining, the reduction in harvested acreage has not been as great as the above figures might suggest. What has been happening, as these data indicate, is that smaller farms have been disappearing as economic and technological changes dictate larger units.

Harvested acreage declined only 7 per cent between 1920 and 1959 to a total of 458 million acres. It is estimated to have dropped another 20 million acres between 1959 and 1961. "Estimates indicate that (if trends in yields since 1950 continue) the food and fiber needs of a population that may be 45 per cent higher by 1980 could be met with 407 million acres of cropland compared with 458 million acres in 1959." 2/

Statistics on numbers of farms of various sizes confirm the fact that the remaining farms are growing larger. Between 1940 and 1959, the number of farms of 100 acres or less declined 52 per cent from about 3.6 million to 1.7 million. In this same period, the number of farms of 260 acres or more increased from

1/ Department of Commerce, Bureau of the Census, Statistical Abstract of the United States, 1968, p. 594.

2/ The Yearbook of Agriculture--A Place to Live, 1963, U.S. Department of Agriculture, p.63.

724,000 (.7 million) to 808,000(.8 million). There was a 35 per cent increase in the number of farms of 1,000 acres or more while the number of farms in all size categories under 260 acres showed a decline. 3/

The changing farm economy and the sharply expanded opportunities for employment in the cities have brought a dramatic decline in farm population. In the short span of 17 years between 1950 and 1967, farm population dropped 53 per cent from 23,048,000 to 10,817,000. Between 1920 and 1967, farm population declined from 30.1 per cent of total U.S. population to 5.5 per cent. In 1966 alone, farm population dropped another 6 per cent in number and its share of total population shrank to 5.9 per cent. 4/

Despite these declines in the number of acres harvested, in the number of farms, and in farm population, agricultural production has not declined. According to the Federal Land Banks, "...manhours worked in farming have dropped 60 per cent during the past quarter century--yet total farm output rose 63 per

3/ Census, op. cit., p. 596

4/ Department of Commerce, Department of Agriculture, Current Population Report, Farm Population, Series Census-ERS P-27, No. 39, May, 1969.

cent, dramatically emphasizing the substitution of capital for labor." 5/ Fifty years ago, one farm worker produced food and fiber for eight people. Today, he can produce enough for 37. Put another way, one hour of farm labor yields more than five times as much food and other crops as it did a half-century ago. 6/

Furthermore, even with the decreasing numbers of farms, more farms have sales of $25,000 and over than was true in 1950, the first year in which such data were collected. (No inflationary factor is involved here, since the index of farm prices received has actually decreased in the period.) Between that year and 1964, the number with sales of this magnitude has more than tripled, from about 103,000 to 337,000, and the proportion of this group to all farms has risen from 2 per cent to 11 per cent. At the same time, the number with sales of under $2,500 has dwindled from 1.6 million to about 350,000 and their proportion from 30 per cent to 11 per cent. (See Table A.)

Crucial in this context is the trend away from the individually owned farm, of whatever size, toward a more complex,

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5/ Advertising supplement to American Banker, op. cit., p.2.

6/ Ibid., p. 1.

corporate structure. The step-by-step liberalization of the eligibility requirements of the Federal Land Banks to include corporate borrowers (see the discussion on pages 6 and 7) speaks as eloquently as would any data on this subject, were they available.

<u>Changes in the Federal Land Bank System and in its Area of Operation</u>

Furthermore, while the economy it served was in transition, the Federal Land Bank System itself has been undergoing change--in aim, in organization, and in market served.

While the reasons for creating a special credit structure for farm finance are not explicitly stated in the statute creating the Federal Land Bank System, the Farm Credit Administration has, over a long period, offered this definition of purpose:

> "This System was created by Congress to meet a definite economic need for a permanent and dependable source of sound farm mortgage credit at reasonable rates and on terms especially adapted to the particular requirements of farmers. It was expected that this farmer-owned credit system designed specifically to provide long-term, low-interest loans on an amortized basis would serve as a pace-setter in solving many of the problems that existed in farm mortgage credit." 7/

At the inception of the System in 1917, the aim appears to have been to provide the farm community--especially the owners

7/ <u>Federal Land Bank System and How it Operates</u>, Farm Credit Administration, Washington, 1965, p.5. Practically identical passages have appeared in earlier editions of the same document.

of family-size farms--with specialized credit facilities particularly suited to agricultural as contrasted with commercial or industrial requirements. It may be assumed that Congress, in enacting the original legislation, considered the question of taxation of the Federal Land Banks and exempted them in the light of then existing conditions. We doubt, however, that Congress at that time could have foreseen the importance of this exemption--in terms of either competitive advantage or loss of revenue--since taxes at that time did not approach present levels. We find no evidence that Congress, in the years since then, has ever reconsidered this exemption.

But while the tax status has not been altered, there has been considerable broadening of the limits within which the Federal Land Banks can make loans. Take, for example, the maximum loan amount, which in 1916 was set at $10,000. In 1923, the limit was raised to $25,000, though it was required that "preference...be given to applications of $10,000 and under." The limit was raised to $50,000 and $100,000 in 1933 and 1949, respectively. In 1955, the maximum was raised to $200,000, and the limit on loans made without prior approval by the Farm Credit Administration was raised from $25,000 to $100,000. In 1959, the ceiling was lifted altogether though FCA approval still had to be obtained on loans of over $100,000.

The result has been a steady expansion of lending activity in the upper ends of the loan range. As Table I shows, 77 per cent of the total amount of Federal Land Bank loans in 1968 (the latest year for which data was available) was for amounts of $20,000 or more. Only 15 per cent was in this category in 1960.

The average size of loan also reveals this trend. From a 1947-49 figure of $4,610, average loan size rose to $21,320--or 362 per cent--in 1965. The average loan size for all lenders, of course, also advanced sharply in this period, under the influence of inflationary trends in the economy generally and of the increasingly larger capital requirements of agriculture, in particular, as its technology advanced and as farm size grew. It is significant, however, that the increase for the Federal Land Banks has been greater than that for all types of lenders and greater than that for any other single group of lenders except insurance companies, which it just matched. Indeed, at least since 1945, the average size of the Federal Land Banks' loan has exceeded that for any other group, except the insurance companies. (See Chart I.)

For example, a Federal Land Bank loan recently made in Alabama was in the amount of $5.4 million.

Further encouraging the expansion of Federal Land Bank lending activity has been the progressive broadening of the definition of eligible borrowers. In the original legislation, this covered only those engaged in, or shortly to become engaged in, the cultivation of the farm to be mortgaged. In 1933, persons who derived the principal part of their income from farming operations were made eligible. Two years later, "person" was redefined to include corporations engaged in raising livestock. There was, however, the qualification that "... no loan ... be made to a corporation (A) unless all of the stock of the corporation is owned by individuals themselves personally engaged in the raising of livestock on the land to be mortgaged, except in the case where the Land Bank Commissioner permits the loan if at least 75 per centum in value and number of shares of the corporation is owned by individuals personally so engaged and (B) unless the owners of at least 75 per centum assume personal liability for the loan." 8/

In 1961, the restrictions on loans to corporate borrowers were relaxed to state: "... but no loan shall be made to a corporation unless the principal part of its income is derived from farming operations and unless owners of stock in the corporation assume personal liability for the loan to the extent

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8/ 12 U. S. C. 1934 ed., Supp. V. 771 (sixth).

required under rules and regulations prescribed by the Farm Credit Administration." 9/

In 1966 and again in 1967, the Federal Land Banks have requested authority to eliminate the statutory loan maximums, the maximum loan which can be made without FCA approval, and the requirements for the assumption of personal liability by stockholders of corporate borrowers.

Greatly liberalizing the scope of Federal Land Bank lending, the Farm Credit Act of 1955 authorized loans for "general agricultural purposes and other requirements of the owner of the land mortgaged." (Emphasis supplied.) In the original 1916 statute, it was provided that loans could be made for the following purposes and no other:

1. To purchase land for agricultural purposes.
2. To purchase equipment, fertilizer, and livestock for proper and reasonable operation of the mortgaged farm.
3. To provide buildings and for the improvement of farm land.

9/ 12 U. S. C. 1958 ed., Supp. V. 771 (sixth).

4. To liquidate indebtedness existing at the time of the organization of the first Land Bank Association in the county or indebtedness subsequently incurred for the above purposes.

With the 1955 amendment, the purpose of Federal Land Bank operations was, consequently, completely altered. From an organization designed to finance farming operations solely, this newly independent system became one authorized to accept farm assets as security for loans to meet any financial requirement of the land owner.

The Federal Land Banks have undergone a series of organizational changes the most importance of which was made in 1953. The Farm Credit Act of that year established the Farm Credit Administration as an independent agency separate from the Department of Agricultural and put the Federal Land Banks on the road to private operation. Since 1947, all federal funds have been out of the System. Thereafter under private ownership and, from 1955, authorized to engage in a broad range of lending business, the Federal Land Banks have moved ahead in the best free enterprise tradition to capture as much business as their unusual competitive advantages make possible.

The steadily growing volume of Federal Land Bank loans--in terms of both number and dollar amount--is shown in Tables

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II and II-A.

Paralleling this growth has been an expansion in the share of the Federal Land Banks of the total agricultural mortgage loan market--an expansion accomplished, as it must be, largely at the expense of tax-paying lenders. As may be seen in Table II, the percentage of total mortgage lending by Federal Land Banks has grown from 12.3 per cent in 1950 to 24.0 per cent in 1965. In the same period, consequently, the share of individuals in this market has been halved--from nearly 30 per cent to 16 per cent--while farm lending by banks and trust companies has declined from 29 per cent to 20 per cent of the total.

Available data indicate that Federal Land Bank lending, far from being confined to, or even concentrated in, the weaker sector of the farm loan market, is widely distributed among all classes of farmers.

Given the Federal Land Banks' stated aims and given the fact that their tax exemption and their favored position as a borrower permit them to charge an interest rate lower than that generally available from institutional lenders, it might be expected that their lending would be disproportionately heavier in the lower end of the range, or, at most, would be distributed among the various classes of farms in a rough equivalence to their proportions among total farms. But this is not the case. A study by the Federal Reserve Board, based on data from the Census Bureau's 1960 Sample Survey of Agriculture, provides the data shown in Tables III and IV. While 10 per cent of all farms had 1960 sales of $20,000 and more, 17 per cent of the farm operators with Federal Land Bank loans were in this category. At the other end of the economic classification, 26 per cent of all farms had sales of between $50 and $50,000, but only 20 per cent of Federal Land Bank borrowers were in this group. (See Table III.)

The average value of land and buildings operated by farmers with major real estate debt in 1960 was about $50,200; land and buildings of Federal Land Bank borrowers had an average value of close to $55,900. (See Table IV.)

Arguments for Taxation

Mortgage bankers feel that the Federal Land Banks should be paying taxes. The Federal Land Banks are, in fact, private enterprise organizations just as surely as any mutually owned enterprise. Even were they not, there are precedents in the Federal National Mortgage Association and the Federal Reserve System for a payment in lieu of taxes or a remittance of profits to the Treasury.

A puzzling aspect of this question lies in the fact that their sister institutions, the Production Credit Associations and the Banks for Cooperatives, are taxed; that proposals for rural electric and telephone banks contemplate that they will be taxed following the retirement of federal capital; and that most people seem surprised to learn that the Federal Land Banks are not taxed. To our knowledge the question of the tax status of the Federal Land Banks was not discussed when the legislation was enacted nor has it been raised in subsequent Congressional hearings.

On the other hand, the tax status of other governmental--or quasi-governmental--corporations has been repeatedly discussed. From hearings and legislation there emerges a consensus that such corporations should be taxed--or, as a minimum, that their tax status should be reviewed--when federal funds are repaid. The failure to provide for either taxation or review in the case of the Federal Land Banks is, we believe, a legislative oversight which should be remedied. Moreover, the exemption imposes an unfair competitive burden on the tax-paying enterprises which also serve the agricultural market. We conclude that the circumstances which led Congress to grant exemption to the Federal Land Banks have changed, that their operations have changed, and that their tax-exempt status is now a proper subject for reconsideration.

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TABLE I

PERCENTAGE DISTRIBUTION OF TOTAL AMOUNT OF FEDERAL LAND BANK LOANS, BY SIZE OF LOAN, SELECTED YEARS, 1960-1968

Size of loan	1960	1961	1964	1965	1966	1967	1968
$ 5,000 and lower	21.9%	20.4%	2.2%	1.4%	0.9%	0.9%	0.8%
$ 5,000 to $8,000	23.3	22.3	5.6	4.3	2.6	2.4	2.3
$ 8,000 to $10,000	11.2	11.8	5.0	3.7	2.4	3.1	2.2
$10,000 to $15,000	18.2	16.7	13.1	10.3	8.6	8.5	8.1
$15,000 to $20,000	10.2	10.6	10.6	9.9	8.8	9.3	9.3
$20,000 and over	15.2	18.2	63.5	70.4	76.7	75.8	77.3
TOTAL, all loans	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Note: See Table IA for greater detail for 1964 and 1965, and a distribution for those years of number of loans by size, which is not available for the earlier years.

Source: Unpublished data of the Farm Credit Administration based on a dependable sample.

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TABLE I - A

PERCENTAGE DISTRIBUTION OF THE NUMBER AND AMOUNT OF FEDERAL LAND BANK LOANS, BY SIZE OF LOAN, 1964 - 1968

Size of loan	Number		Amount		Number		
	1964	1965	1964	1965	1966	1967	1968
$ 5,000 and lower	11.4%	8.3%	2.2%	1.4%	6.7	6.8	6.3
$ 5,000 to $8,000	16.6	15.0	5.6	4.3	10.8	9.6	10.1
$ 8,000 to $10,000	10.6	9.2	5.0	3.7	7.2	8.8	7.1
$10,000 to $15,000	20.5	18.9	13.1	10.3	18.9	17.7	18.6
$15,000 to $20,000	11.8	13.0	10.6	9.9	13.9	13.7	15.2
$20,000 to $25,000	7.6	9.9	8.8	9.7	9.9	10.3	9.6
$25,000 to $35,000	9.5	10.0	14.4	12.8	12.6	12.1	11.6
$35,000 to $50,000	6.3	6.6	13.5	12.2	9.4	10.0	9.4
$50,000 or more	5.7	9.1	26.8	35.7	10.6	11.0	12.1
TOTAL, all loans	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Unpublished data of Farm Credit Administration based on a dependable sample.

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TABLE II

DOLLAR AMOUNT OF FARM MORTGAGES MADE OR RECORDED, BY TYPE OF LENDER SELECTED YEARS, 1920 - 1967

Year	Federal Land Banks	Life Insurance companies	Banks and Trust companies	Individuals	Miscellaneous lenders	Total, all lenders
			Dollar amount			
1920	$ 67,000	$386,800	$ 663,200	$2,142,800	$ 366,200	$3,625,800
1930	47,100	173,700	355,200	618,200	170,600	1,364,600
1940	63,900	145,600	219,800	225,600	117,400	772,500
1950	203,100	348,000	471,600	491,800	140,800	1,655,900
1955	482,700	507,000	582,000	565,900	264,200	2,401,900
1960	520,213	413,337	541,022	612,481	482,682	2,569,735
1965	1,237,876	964,080	1,036,524	811,594	1,108,046	5,158,120
1966	1,344,610	909,341	1,055,992	934,882	1,195,341	5,440,166
1967	1,266,533	695,625	1,036,109	860,318	1,216,460	5,075,045
			Percentage distribution			
1920	1.9%	10.7%	18.3%	59.1%	10.1%	100.0%
1930	3.5	12.7	26.0	45.3	12.5	100.0
1940	8.3	18.8	28.5	29.2	15.2	100.0
1950	12.3	21.0	28.5	29.7	8.5	100.0
1955	20.1	21.1	24.2	23.6	11.0	100.0
1960	20.2	16.1	21.1	23.8	18.8	100.0
1965	24.0	18.7	20.1	15.7	21.5	100.0
1966	24.7	16.7	19.4	17.2	22.0	100.0
1967	25.0	13.7	20.4	17.0	24.0	100.0

Source: Farm Credit Administration, Research and Information Division

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TABLE II - A

NUMBER OF FARM MORTGAGES MADE OR RECORDED, BY TYPE OF LENDER
SELECTED YEARS, 1940-1967

Year	Federal Land Banks	Life insurance companies	Banks and trust companies	Individuals	Miscellaneous lenders	Total all lenders
			Number			
1940	26,258	25,285	110,083	135,037	28,674	325,337
1950	42,820	35,649	126,012	115,805	32,069	352,355
1955	60,490	34,082	114,048	86,586	41,825	337,030
1960	43,090	18,476	85,141	62,176	57,456	266,339
1965	58,050	24,011	92,895	47,453	82,378	304,787
1966	53,643	19,062	84,164	46,168	74,870	277,907
1967	48,189	13,485	79,116	40,446	70,480	251,716
			Percentage distribution			
1940	8.1%	7.7%	33.8%	41.5%	8.8%	100.0%
1950	12.2	10.1	35.8	32.9	9.1	100.0
1955	17.9	10.1	33.8	25.7	12.4	100.0
1960	16.2	6.9	32.0	23.3	21.5	100.0
1965	19.0	7.9	30.5	15.6	27.0	100.0
1966	19.3	6.9	30.3	16.6	26.9	100.0
1967	19.1	5.4	31.4	16.1	28.0	100.0

Source: Farm Credit Administration, Research and Information Division.

TABLE III

ALL FARM OPERATORS AND FARM OPERATORS WITH FEDERAL LAND BANK MAJOR REAL ESTATE DEBT, BY ECONOMIC CLASS OF FARM, 1960

Economic class of farm	Number (in thousands)	Per cent of all farms	Per cent of commercial farms
		All farm operators	
Total, all farms	3,247	100.0%	—
Noncommercial farms	986	30.4	—
Commercial farms, total	2,261	69.6	100.0%
Class I	105	3.2	4.6
Class II	228	7.0	10.1
Class III	490	15.1	21.7
Class IV	590	18.2	26.1
Class V	541	16.7	23.9
Class VI	307	9.5	13.6
		Operators with Federal Land Bank loans	
Total, all farms	254	100.0%	—
Noncommercial farms	48	18.9	—
Commercial farms, total	206	81.1	100.0%
Classes I and II	43	16.9	20.9
Classes III and IV	113	44.5	54.9
Classes V and VI	50	19.7	24.2

Definitions: Economic class of farm by value of farm products sold --
I - $40,000 and over;
II - $20,000 to $39,999;
III - $10,000 to $19,999;
IV - $5,000 to $9,999;
V - $2,500 to $4,999;
VI - $50 to $2,499.

Noncommercial farms are in general those with sales of $2,499 or less.

Source: FARM DEBT, Data from the 1960 Sample Survey of Agriculture; Board of Governors of the Federal Reserve System, 1964. Table 1, page 3; Table 31, page 119.

July 31, 1969

TABLE IV

AVERAGE VALUE OF LAND AND BUILDINGS OPERATED, BY ECONOMIC CLASS OF FARM, FOR SELECTED OPERATORS, 1960

Economic class of farm	All operators with major real estate debt	Federal Land Bank borrowers
Commercial farms, total	$ 61,796	$ 64,166
Classes I and II	163,049	155,629
Classes III and IV	45,156	47,848
Classes V and VI	19,378	22,193
Noncommercial farms	15,961	20,250
All farms	50,187	55,866

Note: See Table III for definitions of economic classes of farms.

Sources: FARM DEBT (Federal Reserve Board report), 1960, Table 1, page 7; Table 31, page 119. Some weighted averages constructed by MTB.

TABLE A

NUMBER OF FARMS BY VALUE OF PRODUCTS SOLD, 1950, 1959, AND 1964

Type of farm	1950 Number	1950 Per cent	1959 Number	1959 Per cent	1964 Number	1964 Per cent
All Farms	5,379,250	100.0%	3,708,022	100.0%	3,157,864	100.0%
Commercial farms						
Total	3,706,412	68.9	2,416,045	65.2	2,165,727	68.6
Sales of:						
$25,000 or more	103,231	1.9	260,121	7.0	336,826	10.7
$10,00 to $24,999	381,151	7.1	535,552	14.4	532,079	16.8
$ 5,000 to $ 9,999	721,211	13.4	653,533	17.6	504,625	16.0
$ 2,500 to $ 4,999	882,302	16.4	617,819	16.7	443,928	14.1
$ 2,499 or under	1,618,417	30.1	349,020	9.4	348,269	11.0
Other Farms	1,672,838	31.1	1,291,977	34.8	992,137	31.4

Note: The categories used by the Census of 1950 were somewhat different from those for the later years; combinations were made to put the data on a common basis.

For definitions of various types of farms, see Table III.

Sources: Department of Commerce, Bureau of the Census; U.S. Census of Agriculture, 1950, 1959, 1964, Volume I and II.

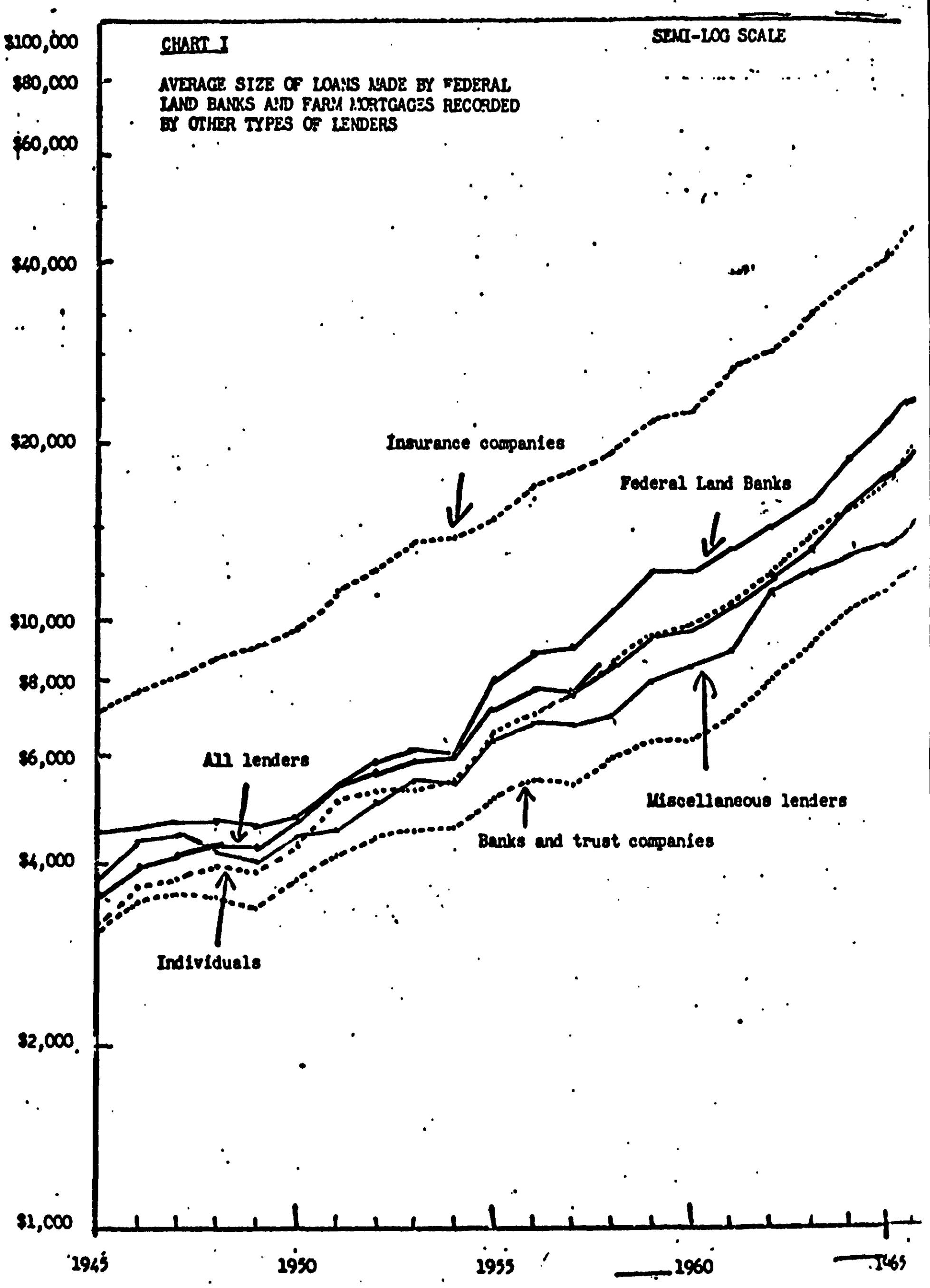

CHART I
AVERAGE SIZE OF LOANS MADE BY FEDERAL LAND BANKS AND FARM MORTGAGES RECORDED BY OTHER TYPES OF LENDERS
SEMI-LOG SCALE
$100,000
$80,000
$60,000
$40,000
$20,000
$10,000
$8,000
$6,000
$4,000
$2,000
$1,000
Insurance companies
Federal Land Banks
All lenders
Miscellaneous lenders
Banks and trust companies
Individuals
1945
1950
1955
1960
1965

91 CONGRESS
1st Session

H. R. 9242

IN THE HOUSE OF REPRESENTATIVES

March 19, 1969

Mr. Utt introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend section 504 of the Internal Revenue Code of 1954, relating to the tax exemption of certain organizations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 504 of the Internal Revenue Code of 1954 (relating to denial of exemption of certain organizations) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) FEDERAL LAND BANKS AND FEDERAL LAND BANK ASSOCIATIONS.--Notwithstanding the provisions of any other law, no Federal land bank or Federal land bank association shall be exempt from the taxes imposed by this subtitle on corporations."

(b) The amendments made by subsection (a) shall be applicable with respect to taxable years beginning after the date of enactment of this Act.

SUMMARY STATEMENT

HARRY NEWMAN, JR.

President, International Council of Shopping Centers
445 Park Avenue
New York, New York 10022

The International Council of Shopping Centers is a trade organization of more than 3,200 members engaged in the development and operation of shopping centers and in their design, leasing, construction and financing. Many chain and independent retail merchants now operating stores in shopping centers are also members of the Council.

Our developer members have built and are operating more than 9,000 shopping centers containing more than 195,000 retail stores in the United States alone. As an industry, shopping centers represent a total investment of more than $54 billion and supply employment for more than 4,500,000 persons.

Before discussing the effect of the Tax Reform Bill on our industry and our view of the consequences for the economy, I would like to express our wholehearted support for the basic aim of the legislation before this committee, namely, the elimination of tax inequities and the minimum-tax approach to achieving it.

The main purpose of our testimony here, then, is to describe to you the grave implications of those provisions in the proposed Act that affect our specialized segment of the real estate industry. In its present form, we believe that the Tax Reform Act of 1969 will have these consequences:

1. It will accelerate the existing trend towards economic concentration of shopping center ownership in the hands of a relatively few large financial institutions and big corporations.

2. It will seriously curtail the construction of smaller centers, which are an essential ingredient in the mass housing programs planned for the next decade. Shopping center developers will not be able to build these centers because they will have no venture capital sources to replace both private investors and those funds normally generated through the sale of their existing centers.

3. This curtailment in turn will eliminate a sizeable number of the almost 14 million new low-skill jobs which the shopping center industry would otherwise create by 1980.

4. The development of fewer new centers means depriving expanding and/or new municipalities and other local government bodies of desperately needed revenues for their operating expenses from property and sales taxes.

5. Expansion of independent merchants, so-called mom-and-pop operations, local chains and other dynamic tenants will be seriously curtailed and in many cases completely halted.

6. The higher yields needed to attract venture captial as compensation for the loss of present tax advantages will lead to increases in already spiraling rents and thus place further inflationary pressures on the prices of consumer goods and services.

7. In order to survive, independent developers will be virtually compelled to merge with large corporations or be taken over by them in order to obtain the high-risk venture capital essential to develop shopping centers.

8. By withdrawing tax inducements from private redevelopers, while preserving subsidies of billions of dollars from HUD, the Act will seriously discourage urban core retail redevelopments, which, in our opinion, deserve the highest priority in both the private and government sectors.

9. It will create serious difficulties for black business and community groups that are now striving to develop shopping centers in the inner-city core areas of at least 50 major cities.

10. Insofar as the real estate industry is concerned, Section 221 was presumably aimed at the passive high-income investor. In fact under this section's definitions and exclusions, virtually every shopping center owner who is actively operating a center will be subject to the limit on interest deductions because practically every shopping center in the country and its leases qualify as "net leases." This, coupled with the Treasury's suggestion that certain business deductions during construction be singled out for Limited Tax Preference treatment, may well drive most individual investors and developers out of a business already made economically marginal by a combination of tight money, record interest rates and skyrocketing construction costs, property taxes and land prices.

WE, THEREFORE, RECOMMEND THAT PRESENT REAL ESTATE TAX INDUCEMENTS REMAIN IN EFFECT, BUT THAT AN EQUITABLE MINIMUM TAX LAW BE ENACTED TO CORRECT THE FEW BUT GLARING INEQUITIES AND ABUSES OF THE PAST.

September 26, 1969

STATEMENT

HARRY NEWMAN, JR., PRESIDENT
INTERNATIONAL COUNCIL OF SHOPPING CENTERS
445 PARK AVENUE
NEW YORK, NEW YORK 10022

Mr. Chairman and members of the Committee: My name is Harry Newman, Jr. I am president of the International Council of Shopping Centers, a trade organization of more than 3,200 members engaged in the development and operation of shopping centers and in their design, leasing, construction and financing. Many chain and independent retail merchants now operating stores in shopping centers are also members of the Council.

Our developer members have built and are operating more than 9,000 shopping centers containing more than 195,000 retail stores in the United States alone. As an industry, shopping centers represent a total investment of more than $54 billion and supply employment for more than 4,500,000 persons.

Before discussing the effect of the Tax Reform Bill on our industry and our view of the consequences for the economy, I would like to express our wholehearted support for the basic aim of the legislation before this committee, namely, the elimination of tax inequities and the minimum-tax approach to achieving it.

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4. The development of fewer new centers means depriving expanding and/or new municipalities and other local government bodies of desperately needed revenues for their operating expenses from property and sales taxes.

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5. Expansion of independent merchants, so-called mom-and-pop operations, local chains and other dynamic tenants will be seriously curtailed and in many cases completely halted.

6. The higher yields needed to attract venture capital as compensation for the loss of present tax advantages will lead to increases in already spiraling rents and thus place further inflationary pressures on the prices of consumer goods and services.

7. In order to survive, independent developers will be virtually compelled to merge with large corporations or be taken over by them in order to obtain the high-risk venture capital essential to develop shopping centers.

8. By withdrawing tax inducements from private redevelopers, while preserving subsidies of billions of dollars from HUD, the Act will seriously discourage urban core retail redevelopments, which, in our opinion, deserve the highest priority in both the private and government sectors.

9. It will create serious difficulties for black business and community groups that are now striving to develop shopping centers in the inner-city core areas of at least 50 major cities.

10. Insofar as the real estate industry is concerned, Section 221 was presumably aimed at the passive high-income investor. In fact under this section's definitions and exclusions, virtually every shopping center owner who is actively operating a center will be subject to the limit on interest deductions because practically every shopping center in the country and its leases qualify as "net leases". This, coupled with the Treasury's suggestion that certain business deductions during construction be singled out for Limited Tax Preference treatment, may well drive most individual investors and developers out of a business already made economically marginal by a combination of tight money, record interest rates and skyrocketing construction costs, property taxes and land prices.

WE, THEREFORE, RECOMMEND THAT PRESENT REAL ESTATE TAX INDUCEMENTS REMAIN IN EFFECT, BUT THAT AN EQUITABLE MINIMUM TAX LAW BE ENACTED TO CORRECT THE FEW BUT GLARING INEQUITIES AND ABUSES OF THE PAST.

WHAT IS THE DEVELOPMENT BUSINESS?

Let me explain something about the nature of the development business before elaborating on the reasons for the ten points of what may seem at first glance to be the shopping center industry's True Bill against the Tax Reform Act.

Shopping centers have enjoyed a remarkable record of successful operation and foreclosures are extremely rare. Because of this performance and the high percentage of so-called AAA-credit, or major chain tenants, in each shopping center, insurance companies and other lenders have come to regard shopping centers as low-risk or no-risk investments.

Once the center is finished, this is an accurate assessment. However, during the development stages, the developer alone, or in conjunction with his equity investor, is exposed to a variety of risks which can jeopardize his investment and, at worst, send him into bankruptcy. These risks and unexpected costs occur from the site selection phase to the point in time after the center is completed and the developer is ready to collect his long-term mortgage funds from the permanent lender. They range from delays caused by frozen ground, snow and rain to strikes, unexpected site conditions, zoning and title problems. They range from mistakes by the architects and engineers to delays because of tenant improvements or tenant bankruptcies. They range from uncontrollable cost increases in construction, financing charges and real estate taxes to breakdowns in deliveries of essential supplies and materials.

There are other hidden risks. For every center that is developed, there are at least 12 that never see the light of day, but may have reached the zoning, layout, or at least the acquisition-negotiation stage. Although it is an extreme example, my company recently investigated 73 individual sites before we found a suitable location for a chain department store. Each of these attempts at finding a shopping center location resulted in relatively substantial expenditures to say nothing of the time involved.

Once the developer has found the site, he must tie up the land on an option or by some other means, so that he has enough time to determine the major tenant's interest in the site. In order to stimulate interest on the part of a supermarket if it is a neighborhood center location, or a department store if it is a regional center site, he must have layouts and economic studies prepared. He must also work out the financial projections for the center to determine the rentals he must get. This involves a high degree of guessing what construction costs and interest rates will be in six months, a year, or two years depending on the size and gestation period for the proposed center.

Assuming he gets the tenant's approval of the site, he must then lease enough of the remaining stores to chain stores or tenants with multi-million dollar net worths to enable him to secure a mortgage loan commitment from an insurance company or other financial institution. At this point the developer normally must purchase the land and this requires substantial cash, usually more than he has available because of his investments in other centers. This explains the importance of the equity investor to the developer's continuing activity.

Once the investor has been brought into the development picture, the developer then has to negotiate his contract with the architect and engineers, negotiate a contract with a general contractor, and complete his leasing negotiations for the other vacant stores. He must coordinate the activities and responsibilities of the architect, contractor and tenants, while making arrangements for a construction loan based on the commitment for his permanent mortgage loan. He must then complete the center according to tenants' plans, move them in, and set up the management, promotion and maintenance of the completed center. Then he can at last "close" the permanent mortgage loan, the proceeds of which are used to pay off the construction loan. The development process cannot be described adequately in such brief terms, but hopefully we have conveyed to you some idea of the complexities, uncertainties and risks which characterize the business.

ECONOMIC CONCENTRATION

More than 90 per cent of the shopping centers in this country are developed by individuals and small independent corporations or partnerships, who provide the skills, manpower and part of the equity investment required for the shopping centers they build. They are not able to develop shopping centers without entering into partnerships with one or more investors in each center. They need these partners to help them put up the equity investment of 10 to 25 per cent normally required for each venture.

These equity investments range from $50,000 to several million dollars each, depending on the size of the center, the cost of land and buildings, and the amount of mortgage financing they can obtain. Very few developers who are actively building new centers can afford (or have the funds necessary) to finance their own centers without partners. Because of the high risks involved and the relatively large amounts of venture capital needed, the investor partners who join the developers in their projects are almost always private parties seeking commensurately high returns on their investment. If they are denied the inducement of tax savings, they will have little reason to invest their money in these projects. They will put their money in other types of investment, and developers will have difficulty getting shopping centers built in the future.

To remain in business, developers will have to find other sources of equity funds. They will have to turn to large corporate investors, to public financing and to institutional investors.

What concerns me and what I think should concern your Committee is that the Tax Reform Act will make it difficult for the independent shopping center entrepreneur to survive and will result in the increasing domination of our industry by large financial and/or corporate interests.

The Committee should be aware that since the 1966 monetary crisis and credit crunch, the shopping center industry has been plagued by a shortage of mortgage funds, record-high interest rates, accelerating construction costs, rising property taxes and skyrocketing land prices. These inflationary pressures are particularly serious for a high-leverage business like shopping center development where the loan usually represents 75 per cent or more of the total project costs. Rents have not risen at a comparable pace and profit margins consequently have been eroded to a point where tax deductions available under the present laws are playing an increasingly vital part in the economics of shopping center development. I refer you to Appendix B, attached to this report, which shows that from 1965 to 1969, land prices, property taxes, construction costs and prime interest rates rose 20 to 88 per cent. During the same period, rental income increased only 12 per cent.

Even before the Tax Reform Act was conceived, high interest rates and other inflationary pressures started to reshape the shopping center industry. Major supermarket chains, discount stores and traditional department stores began to develop their own free-standing branches, tending to eliminate the independent developer. In addition, lending institutions began to insist on a piece of the equity and demanded a share of minimum and/or overage rents as a prerequisite for a mortgage loan. As a result of these and other factors, the position of the independent developer has been increasingly threatened.

The Tax Reform Act will accelerate the trend towards the concentration of ownership, operating control of the industry, and a virtual monopoly of most new developments in the hands of big corporations and big institutional investors. I am not suggesting that they even want this control, but under the changed dynamics of the industry they will be the only ones who can afford it.

FEWER SMALL CENTERS

Since their inception, shopping centers have attracted hundreds of new business enterprises and opened opportunities for hundreds of individuals and groups to become engaged in development as independent entrepreneurs.

This has, in fact, been the history of my own company. I am before you now to fight for the life of my company and hundreds of others like mine, and to retain our ability to continue as independent entrepreneurs in a competitive, viable economy.

Let us examine for a moment what will happen to neighborhood centers if the private investor and independent developer are eliminated as economic factors.

In order to weigh the importance of the small center in the consumer economy, keep in mind that out of 10,820 shopping centers operating at the end of 1968, 9,300 (almost 90 per cent) were neighborhood or community centers.

Because size is equated with financial return, institutional developers are primarily interested in developing and owning regional centers where the retail action is concentrated in the hands of the large retailers and national retail chains. Smaller centers do not have the "economic glamor" and are too small to attract the financial institution as an investor, joint venturer or developer.

With the private investor removed from the scene, who is going to develop the literally thousands of neighborhood centers needed to service the 2,300,000 new houses scheduled for construction every year for the next decade? Competition will be curtailed or eliminated. Where this happens, the Act will create captive-market conditions which encourage price exploitation and which have been a significant factor contributing to minority unrest and riots in slum areas.

LOSS OF JOBS

The retailing industry traditionally has provided substantial numbers of jobs for people who rank at the lowest economic level in the community. It is questionable if the economy will be able to absorb those individuals who may be displaced from retailing operations, since many of them have very limited employment skills.

Based on the estimate that 2-1/2 new full-time jobs are created for every 1,000 square feet of gross leasable area, almost 14 million jobs can be created by the development of shopping centers in the next 11 years. The Tax Reform Act in its present form will jeopardize a substantial number of those jobs, mostly unskilled, the most difficult to place in other sections of the economy.

LESS TAXES FOR LOCAL COMMUNITIES

Those shopping centers which have been built this year or will be completed by the end of 1969 will contribute $25 million in property taxes to the communities in which they are located.

This is especially welcome because it is premium revenue. Shopping centers, at their expense, provide many of the services normally required from the local municipality, for example, parking areas, sidewalks, malls, landscaping, lighting, security, trash removal, parking lot maintenance and repair. Developers also frequently dedicate land for streets and put in the streets, curbs, gutters and sometimes the sewage system, fire hydrants and the water distribution system.

By 1980, in order to service the projected 30 million growth in population, the number of shopping centers will double, adding viable local tax revenue to local municipalities and communities.

The Tax Reform Act, if passed in its present form, could drastically reduce the number of new centers to be built and deprive new, expanding and redevelopment communities of critically needed tax revenues.

SMALL RETAILERS JEOPARDIZED

The private investor's willingness to risk his money in shopping center development has been largely responsible for helping "mom-and-pop" stores convert to franchise operations. Franchise operations have had a phenomenal growth record. They range from fried chicken and roast beef sandwiches to auto brakes, mufflers and bridal wear. The investor's dollar has also made economically viable the smaller centers with their inevitable complement of barber, beauty, cleaner-type of service shops.

Shopping centers create small retail businesses. If shopping center development is curtailed, there will perforce be fewer opportunities for small retailers to go into business and to expand their operations.

INCREASED INFLATIONARY EFFECTS

At the present time, private investors like lawyers, doctors, small businessmen, etc., who constitute the majority of shopping center equity investors, are willing to risk their savings for an 8 or 9 per cent return coupled with tax advantages which enable them to offset some of their ordinary income.

Remove these inducements, and how marketable a commodity does the shopping center developer have?

Apart from the extensive risks involved during the developmental stage, shopping centers have one other major drawback from an investment viewpoint--lack of liquidity. Unlike shares on the stockmarket, a shopping center with its multiple tenancies and other complexities, and special requirements, not the least of which is a large cash investment, is difficult to sell. By removing the accelerated depreciation provision and other tax advantages for second owners, the new law will make centers virtually impossible to sell.

It might seem that there is a simple solution to this dilemma--increase the yield to compensate for the loss of tax advantages.

The only way to achieve this is to raise rents even further. We have already witnessed the lag in rental increases behind the spiraling costs of development.

In our opinion, rents cannot be increased enough to provide the additional yield which investors in this non-liquid, high-risk field might reasonably demand, without jeopardizing the survival of the retail merchant and placing irresistible pressure on the retailer to try to pass on his increased occupancy cost to the consumer in the form of higher prices.

Neither Congress nor the shopping center industry wants to penalize the consumer and speed inflation in order to correct a few inequities in our tax structure.

MERGE OR SELL OUT FOR SURVIVAL

As cited earlier, the elimination of the private investor and the inability of developers to attract financial institutions as investor-partners will hamstring most independent development activities. In addition, because developers will be unable to sell their centers under the proposed law, new projects will dry up or atrophy. Unable to recoup their investments on existing centers and facing high costs of land and money, developers will not be able to undertake new projects at the very time that the demands for new retailing facilities and their own operational needs dictate that these projects be initiated.

The ultimate effect of the provisions in their present form will be to force shopping center developers to incorporate, to merge with large corporations, or to go out of business.

This trend has already become apparent as a result of prevailing economic conditions. Suppliers of building materials, diversifying corporate giants and insurance companies in the past two years have bought existing development firms with experience and expertise, who were being pinched by under-financing and the critical money shortage.

H.R. 13270 contains a number of provisions, namely Sections 411, 412, 413 and 414, specifically designed to inhibit the trend towards economic concentration which has occurred because of the recent waves of corporate mergers and acquisitions. In fact, the House Ways and Means Committee report notes that "this trend in merger activity raises numerous significant questions, such as its effect on the competitive climate in the United States, and the overall effect of this activity on the U.S. economy." The House considered this trend towards economic concentration to be so disturbing that it deemed it advisable to utilize the tax laws to impose a number of restraints upon such corporate merger activities. Nevertheless, in the very same bill, the House has approved a number of changes with respect to the tax tfeatment available for real estate activities, which inevitably will lead to economic concentration within the shopping center industry.

The evil of economic concentration within any industry is obvious. If the ownership of shopping centers is concentrated in the hands of a relatively small group of large landlords, the bargaining position of any prospective tenant, large or small, will be seriously compromised.

To see how the proposed legislation, coupled with present economic conditions, will encourage mergers and acquisitions, one need only look at the tract housing industry, where the small independent developer has become an anachronism and virtually disappeared from the scene.

SET-BACK FOR URBAN REDEVELOPMENT

Most of the successful urban redevelopment projects completed to date have been the work of private entrepreneurs. Many shopping centers are planned as part of the redevelopment of core areas, but developers have learned that this type of project involves at least twice as much time and documentation as conventional projects.

My own organization's experience is typical. We are general partners in a redevelopment project in the downtown area of Richmond, California, which will embrace 30 city blocks and in its completed form consist of 1,300,000 square feet of retail space. We have spent many thousands of dollars on legal fees, economic studies, plans, renderings and brochures for prospective tenants (See photographs). However, because the proposed project is now ringed by a predominantly black, low-income slum area, we are encountering difficulty and delays in persuading major department stores that the entire environment will be dramatically altered by the proposed development, and that the 825,000 potential customers in the primary and secondary trading areas will insure as profitable an operation as a white suburban community.

As developers we wanted to undertake this project because of the social benefits to the community as well as the prospect of a sound return on our investment of time and money.

HUD's subsidy of the land and the city's willingness to provide a $10 million parking structure have made the project economically viable and have given us a substantial inducement to proceed. Relying on the tax treatment permitted under the present law, we and our partners decided to tackle the special problems involved in a redevelopment project of this magnitude.

It seems paradoxical that with one hand the government could create inducements for developers to tackle such assignments and with the other remove equally significant inducements.

If H.R. 13270 is passed, we would be forced to re-examine our potential return on investment in relation to the additional time and risks this project would entail. Our response, I believe, is typical of others involved in urban retail redevelopment projects.

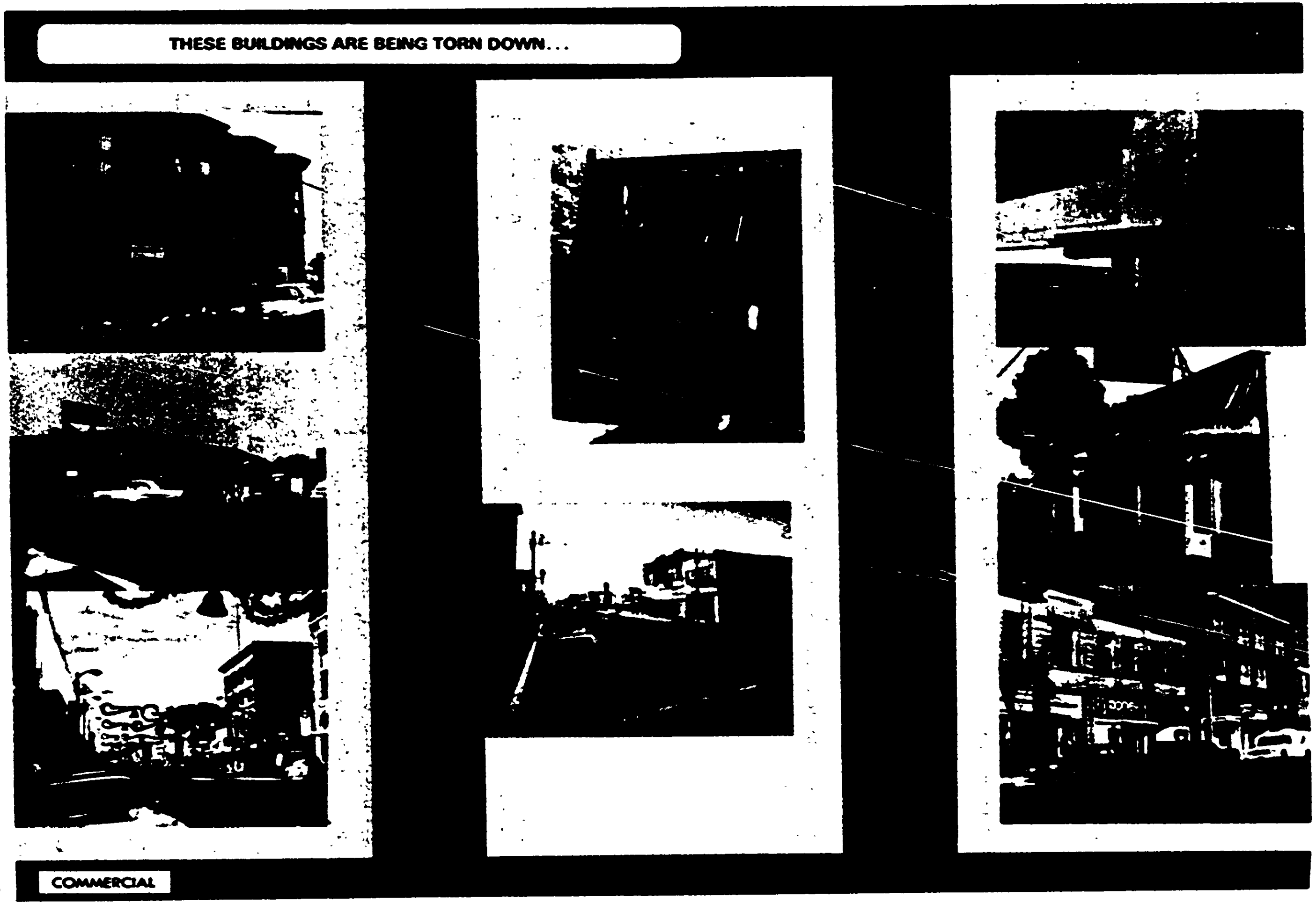
BLACK SHOPPING CENTER DEVELOPMENT

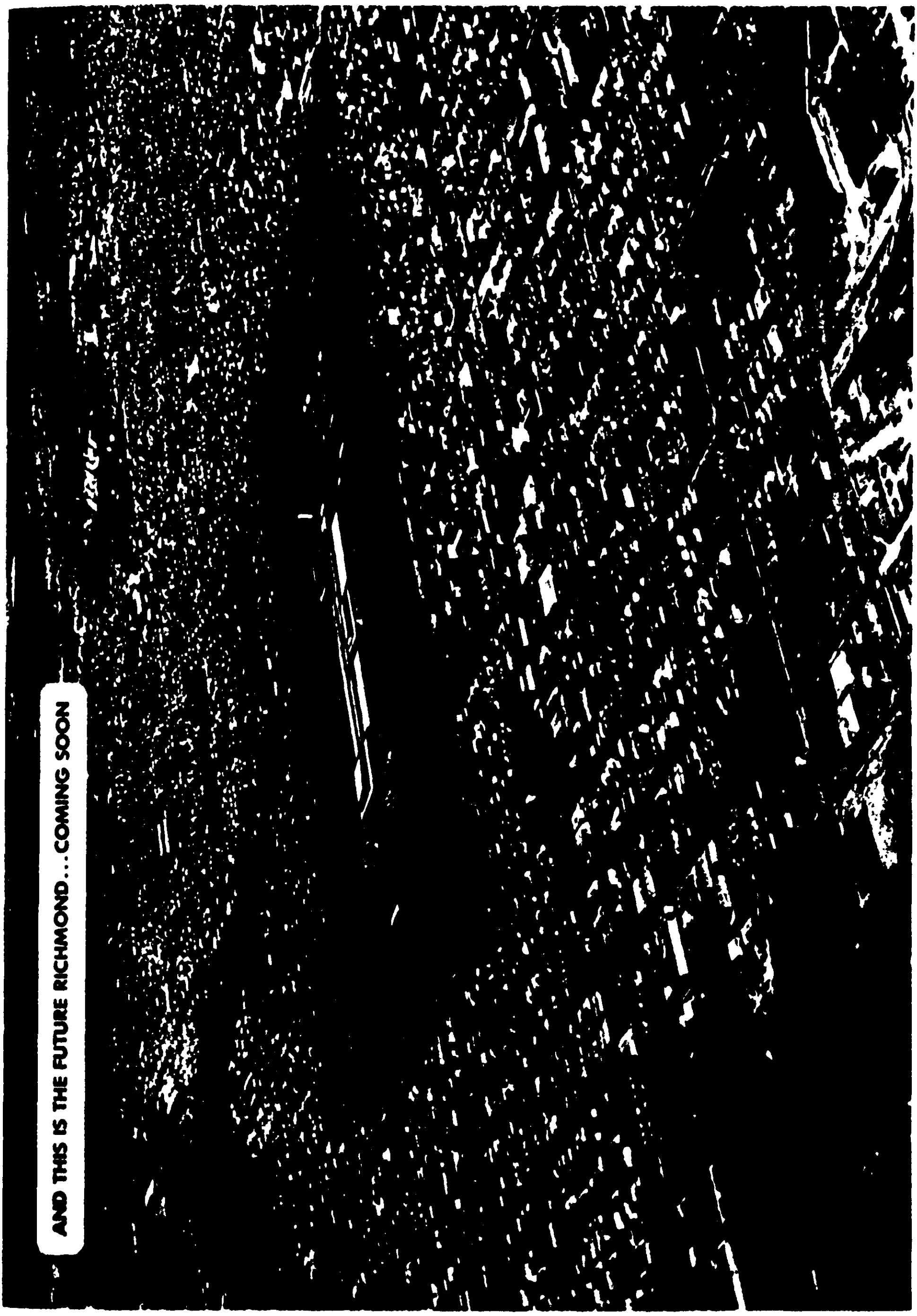
The International Council of Shopping Centers has played an active role in helping to train black businessmen and community groups who are now attempting to develop shopping centers in at least 50 major cities. These centers will help to redevelop slum areas. They will help set up new businesses. They will create jobs for members of minority groups.

These centers need every possible financial assistance to become economically self-sufficient. Unless they are able to avail themselves of accelerated depreciation and other tax reductions, they will have added obstacles to overcome.

NET LEASE HAS WRONG TARGET

In the shopping center industry, Section 221 of H.R. 13270 will apparently apply not only to the passive investor, but also to the active developer. Under the definitions in the law, most shopping centers and their leases would qualify as "net leases." The allowable operating expenses (as defined) rarely exceed


THESE BUILDINGS ARE BEING TORN DOWN...
COMMERCIAL



AND THIS IS THE FUTURE RICHMOND . . . COMING SOON

15 per cent of rental income in virtually all shopping centers and/or shopping center leases.

We cannot believe that the House intended the entire shopping center industry to come within the scope of this provision.

Section 221 will effectively rule out real estate for all investors except those with substantial amounts of liquid funds but seeking a much higher return on investment than is now available.

Shopping center developers are in the "trade" and/or "business" of developing and operating shopping centers. They are not passive investors. Yet the Limitation on the Deduction of Interest applies to developers as if they were passive investors and rules them out of the "trade or business." Section 221 creates other inequities as well, which were pointed out by the Treasury when it recommended that Section 221 be deleted. We strongly support their stand.

CONCLUSION

The shopping center industry is already in a precarious position. Rising interest rates appear to be only a nuisance to large corporations. For shopping center developers, they are a disaster. A 1 per cent increase in the mortgage loan rate, for example, reduced the yield on invested capital in one of our recent centers by 75 per cent. Profit margins are being eroded further by runaway construction costs, land prices and rising property taxes unrelated to income.

The most recent Treasury proposal to treat interest, taxes and rents paid by a developer during the period of construction as Limited Tax Preference items would impose yet another burden upon the developer.

This proposal together with the serious immediate repercussions and long-range consequences of those provisions of the Tax Reform Act affecting our industry have a cumulative effect. They may represent the breaking point for the shopping center industry. Although the economy might conceivably survive its demise, such is obviously not the purpose of either the House or the Senate.

The serious implications of such an eventuality in the form of lost jobs, inadequate retail facilities, inflationary pressures, curtailment of tax revenue for local government bodies, retarded urban redevelopment, and perhaps most serious, accelerated economic concentration cannot be overlooked or underemphasized.

I wish to emphasize that we favor a minimum tax for every taxpayer. H.R. 13270, however, excluded the oil industry from its provisions. The Treasury now recommends excluding interest on municipal and state bonds along with the appreciated value of assets contributed to charity. This would be manifestly unfair to the real estate industry and to the so-called gentleman farmer. In our opinion, there should be a minimum tax and everyone should pay it.

Finally, there is a basic social and philosophical principle at stake in this bill. America and its economy have been built by risk-takers, the entrepreneurs. America has motivated men to take these risks by offering them incentives.

Our shopping center industry also has been built by risks and skills activated by incentives. At a time when it is trying to weather the economic storms for survival, we genuinely hope that you will recognize the industry's contribution to our society and not deprive it of its most crucial driving force.

I appreciate this opportunity to present our viewpoint to you and respectfully hope that our observations may help you in your deliberations.

APPENDIX 'A'

SHOPPING CENTER INDUSTRY STATISTICS

In the aggregate, the shopping center industry in the United States represents an investment of approximately $33.4 billion in construction alone. An additional $21 billion is estimated to have been expended to equip the retail stores in the nation's shopping centers. They currently supply employment for an estimated 4,500,000 persons.

In the next dozen years, 1969 through 1980, shopping center construction (if permitted to occur by the tax law, and by the cost and availability of money) and equipment installed in shopping center stores would require the expenditure of an estimated $180 billion (in 1968 dollars). *This expenditure is exclusive of money spent for land.

By 1980, shopping centers, if built according to our projections, will account for the annual employment of some 18,440,000 persons. Although managers and department heads are highly skilled persons, a very large proportion of retail workers are relatively unskilled and, in a large number of cases,are marginal employees. The unskilled and marginal employees, many of them part-timers, would in many cases find it difficult to obtain other employment and would have to be supported by the public treasury. Many are employed at or close to minimum wages, adjusted for urban or non-urban factors.

Shopping centers in the United States currently account for 42 per cent of all retail trade, exclusive of automobiles, service stations, hay, grain, feed, fuel, ice and lumber. By 1980, their share of the retail market should approximate 50 per cent.

For 1968, retail sales in shopping centers in the United States were some $87.8 billion dollars. They are projected at $94.5 billion for 1969.

The overwhelming majority of shopping centers in the United States are small projects. Centers of less than 100,000 square feet number 6,500, and centers running from 101,000 square feet to 200,000 square feet number 2,800. To round out the picture, centers from 201,000 square feet to 400,000 square feet number 1,000, and centers larger than 401,000 square feet number 520, as of the end of 1968.

*Shopping center construction would make up some 90 per cent of total retail store construction.

APPENDIX 'B'

A COMPARISON OF INCREASES IN KEY ITEMS OF SHOPPING CENTER COSTS, 1965-1969

		1965	1967	1969	Increment 1965-1969
1.	Prime Interest Rates	4.5%	5.6%	8.5%	88.9%
2.	Construction Cost Index	117.2	130.2	148.7	26.9%
3.	Property Tax Index	128.4	148.1	165.0	28.5%
4.	Land Price Index	100	110	120	20.0%
5.	Shopping Center Rents	$ 1.83	$ 1.94	$ 2.05	12.0%

Notes and Sources of Data:

1. U.S. Housing Foundation, August 1969
2. Construction cost index by E. H. Boeckh, Commercial and Industrial Buildings, as reported in Survey of Current Business, U.S. Department of Commerce (various issues)
3. Price deflator index for retail component of GNP, as reported in Survey of Current Business, U.S. Department of Commerce (national income issue)
4. Commercial land price index (estimate by ICSC based on 5% land cost appreciation per year)
5. Average rents in regional shopping centers per square foot of gross leasable area -- Dollars and Cents of Shopping Centers published by Urban Land Institute

SUMMARY OF
STATEMENT OF PHILIP N. BROWNSTEIN
ON BEHALF OF THE COUNCIL OF HOUSING PRODUCERS
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

September 26, 1969

Housing production is totally dependent upon capital availability. In the case of sales housing the need is primarily for mortgage credit. While this, of course, is equally true with respect to the production of rental housing, in the latter case there is the added need for long term equity capital. And this need for equity investors is what is concerning the Council in the tax measures now being considered by the Congress.

Of particular concern to the Council is the proposed elimination of accelerated depreciation on existing residential property and the treatment of recaptured equity as ordinary income to the extent that accelerated depreciation has been taken on new residential property during the period of initial ownership.

The Council is also concerned about the depreciation formula for commercial property. The lack of commercial facilities will seriously hamper the development of new areas, especially those in outlying regions and in new communities.

Since the life line of production of housing is mortgage credit and since the major suppliers of this credit, particularly for home financing, have been the thrift institutions, the Council would urge that this be considered when looking at the tax structure of these institutions.

STATEMENT OF PHILIP N. BROWNSTEIN
ON BEHALF OF THE COUNCIL OF HOUSING PRODUCERS
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

September 26, 1969

Mr. Chairman and Members of the Committee:

I appreciate the opportunity of appearing here today on behalf of the Council of Housing Producers. The Council was founded in February, 1968, to provide leadership in the broader involvement by private industry with government in helping meet the nation's housing needs. It is comprised of 15 of America's largest housing producers.

The Council completely supports the housing goals established in the Housing and Urban Development Act of 1968 and intends to use all of its resources in trying to see that these goals are achieved. It also supports Secretary Romney's efforts in Operation Breakthrough, and a number of members contemplate submitting proposals for consideration. We are hopeful this will demonstrate that relieved of some of the existing constraints and impediments, meaningful savings in housing construction may be achieved.

Housing, as you know, is always adversely affected disproportionately during periods of monetary restraint. This is now occurring, and as a consequence we are witnessing a substantial decline in housing starts instead of the increase needed to begin meeting our housing goals. The rosey pronouncements which accompanied the passage of the 1968 landmark legislation are indeed taking on a somber hue. Starts have dropped from an adjusted annual rate of nearly 1.9 million in January of this year to about 1.3 million in August. If the trend in the availability of mortgage credit is not promptly reversed, it is likely that by year end housing starts will have declined to even considerably lower levels.

Housing production is totally dependant upon capital availability. In the case of sales housing the need is primarily for mortgage credit. While this, of course, is equally true with respect to the production of rental housing, in the latter case there is the added need for long term equity capital. And this need for equity investors is what is concerning the Council in the tax measures now being considered by the Congress.

The Council was gratified that the measure approved by the House recognized the need for continuing accelerated depreciation for new residential construction. Also, the encouragement given to rehabilitation by permitting the amortization of such expenditures over a 60 month period may stimulate activity in this important area which has too long been neglected.

Real estate investments by their very nature lack liquidity and carry a high degree of risk. It is fairly customary that during the early life of a rental project, during the so-called rent-up period, not only is no income generated but, in fact, the project often shows a deficit due to the excess of operating expenses over rents received. In the case of housing projects built under the subsidy programs of HUD and sponsored by limited dividend groups, the return to the investor is limited 6% on the amount of the investment. With the yield on Government securities approaching 8% and on good grade corporate bonds exceeding that amount, it is clear that the attractiveness of HUD's limited dividend investment programs is not the cash return. This is also true to a large degree in conventional, non-subsidized projects. The interest of equity investors is sparked largely by the tax advantages which the investor receives. As a matter of fact, the National Corporation for Housing Partnerships, created by the 1968 Housing Act to assist in the production of low and moderate income-housing, and which is just getting underway, depends in great measure of the tax benefits to give its investors a satisfactory return. This was contemplated in the legislation, and it is the basis on which the incorporators and officers have proceeded.

The major concern of the Council with regard to the legislation under consideration is that relating to the depreciation provisions respecting residential property and with the tax treatment provided for recapture in the event of sale. But there are two other important provisions having a bearing on residential property production which will be mentioned briefly.

First, as indicated earlier, the life line of housing production is mortgage credit. The principal suppliers of this credit, especially in the home financing field, have been the thrift institutions -- savings and loan assocations and mutual savings banks. The effect of high returns on other investments, including government securities, has taken its toll on these institutions as they have suffered heavy withdrawals of savers' funds. This is being felt in the home building industry. Financing commitments are difficult, and at times impossible, to obtain simply because funds are lacking. Undoubtedly these are matters which the Congress will want to consider when looking at the tax structure of these institutions.

Mortgage investments must be encouraged -- not discouraged. To meet the housing goals Congress established by the 1968 Housing Act -- 26 million units during the next 10 years -- capital must be attracted from other sources. The Ginny Mae collateralized mortgaged notes hopefully will attract new credit sources, such as pension and welfare funds, but the investment itself still must be attractive. The entire base of investment capital in housing must be widely broadened if these goals are to be met.

The second item on which we would like to touch is the depreciation formula for commercial property. Residential and commerical development often go hand in hand. In areas being newly developed, adequate commercial facilities are essential if residential construction is to proceed. If construction of commercial facilities should become unattractive to investors, it will seriously hamper the development of new areas, especially in outlying areas and in connection with the undertaking of new communities. We would urge that these considerations be given effect in determining the tax treatment to be accorded commercial real estate.

Of particular concern to the Council is the proposed elimination of accelerated depreciation on existing residential property and the treatment of recaptured equity as ordinary income to the extent that accelerated depreciation has been taken on new residential property during the period of intial ownership.

An investor is willing to risk the capital required to develop residential property only if the prospects for receiving what he believes is an adequate return are reasonably good. Inherent in the plans of many of those willing to supply the necessary equity capital is the contemplation of accelerating the depreciation allowance for a number of years in order to raise the effective yield from the investment to an amount reasonably commensurate with the risks and in keeping with the competitive demand for investment capital. Such plans further contemplate the sale of the property when this yield can no longer be obtained. This can be done because there is a ready market of other equity investors who are looking for investments which supplement a limited return with a tax benefit derived through property depreciation allowances. If the depreciation allowance is reduced and the investment accordingly is no longer as attractive as other investment opportunities, the market on existing projects will become quite limited. This being the case, investors will be most reluctant to undertake new projects knowing that when retention is no longer profitable there may be difficulty experienced in effecting a sale at a reasonable price.

This can have a very serious effect also on the existing supply of rental property. If investors are unable, in effect, to augment their yield through the allowance for depreciation, there is only one other way to increase the yield they believe their equity investment warrants. That would be by increasing rentals to compensate for the return which is otherwise lost. As a consequence, this could mean very substantial rent increases on the hundreds of thousands of rental units in which this would be an important factor. Very likely, the savings in tax to the individual through tax reform measures would be totally lost through increased rents.

The tight rental housing market with which most areas are faced today, and indeed this is acute in some areas, very nearly eliminates any options on the part of the tenants to seek other accommodations. According to Census Bureau statistics available housing is at its lowest level since 1957 with the vacancy rated at 5% of the supply during the second quarter of this year for rental units and less than 1% for sales housing. Rental housing availability has been shrinking steadily from 7.7% in late 1965 and homeowner vacancies are off from 1.4% in 1966.

Faced with rent increases which must assuredly follow a decrease in the production of rental units, the public must either allot a disproportionate share of their income to shelter cost or possibly go into a substandard unit. The scarcity of available housing actually is a major contributing factor to inflation. Any move in the direction of further retarding housing production by discouraging private investment will certainly be counter productive by worsening the housing shortgage and forcing up rentals thus aggravating inflationary conditions.

The provision in the House approved bill which would tax as ordinary income all or most of the gain on the sale of investment property, that is the amount attributable to the benefit derived from accelerated depreciation is equally serious. As a matter of fact, it virtually negates the advantage ostensibly given to the production of new residential construction by permitting accelerated depreciation in the first instance. What it really does is merely defer the tax payment. Not only does it require the taxation of the accelerated depreciation at ordinary income rates, but the bill would also make the entire amount of deferred income payable in the year of sale. This large sum payable in one taxable year would be a further deterrent to equity investors. Given various investment alternatives, it is quite probable that much of the needed capital would be channeled to other sources.

The need is for an inducement to the equity investor to risk his capital so that we can begin a program of housing production which will meet our Nation's needs. Housing production, as pointed our earlier, is suffering from the effects of a restrictive monetary policy. To aggravate further this critical condition by superimposing tax laws which discourage the investment of equity capital in the housing industry could well create an imbalance in the economy of our country which will be borne by the segment of our population who can least afford it, that is the low and moderate-income family that must rent its shelter. We are well behind the production schedule necessary to be maintained in order to meet the 10 year housing goals. We can ill-afford additional impediments which will not only make the goals impossible of achievement in eliminating substandard housing, but may indeed help to bring about even more severe housing shortages in many areas.

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SUMMARY
OF
STATEMENT OF JOSEPH F. SEXTON
Chairman, Federal Legislative Committee
of the National Apartment Association

September 26, 1969

The National Apartment Association recommends that H.R. 13270 be amended to retain the 150% declining balance method of depreciation on used apartments. The straight-line method is unrealistic in the light of the long useful lives which the Treasury has insisted upon, lives which do not reflect technological obsolescence. So unrealistic is the straight line method that denial of the 150% method will seriously limit the resale market, thereby discouraging the development of new multifamily projects. The July 24th cutoff date has already had a serious impact by discouraging investors from purchasing apartments.

Our Association strongly objects to the harsh recapture provision in the House bill which would tax all the gain on the sale as ordinary income to the extent of the depreciation taken in excess of straight-line. No attempt is made to differentiate between the short-term holder and the long-term investor; certainly this underscores the unreasonableness of this provision. The Association recommends instead that during the first five years of the holding period the depreciation taken in excess of straight-line be taxed as ordinary income but thereafter the percentage of gain taxed as ordinary income be reduced 1% per month. Certainly one who holds property more than 13 years should be entitled to have all his gain taxed at capital gains rates.

The limit on tax preferences (LTP) was originally devised to prevent high income persons from escaping taxation. As it has now been watered down, hobby farming may escape it by the use of accrual method of accounting; oil is exempted from it; the bulk of the income from municipal bonds is exempted; and the Treasury has recommended deletion not only of any reference to state and municipal bonds but also the appreciated value of assets donated to charity. Thus the prime target of this area now turns out to be real estate - the one area in our economy which can stand the least the cutback which would inevitably result from the provisions in the House-approved bill.

While our economy grew at a rate in excess of 5% in the last 8 years and capital investment grew at a rate of almost 10%, housing starts grew at a rate of only ½ of 1%. If we do not stimulate housing, we will find a situation in which the shortages will be further compounded, in which rents will then be forced to rise because of lack of supply. This will cause extreme dislocation to our economy and will produce more people in need of subsidized housing, which is just the opposite of our national goal. Our goal should be an increase of supply through tax incentives, if necessary, rather than a reduction through elimination of existing incentives.

STATEMENT OF JOSEPH F. SEXTON, INDIANAPOLIS, INDIANA, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE, NATIONAL APARTMENT ASSOCIATION, BEFORE THE SENATE FINANCE COMMITTEE IN REGARD TO H.R. 13270, THE TAX REFORM ACT OF 1969

September 26, 1969

Mr. Chairman and Members of the Senate Finance Committee . . .

I wish to take this opportunity to thank you for the privilege of appearing before you today on behalf of the National Apartment Association, an organization of some 16,000 members involved in the ownership and management of apartments throughout the United States.

Our general prepared testimony deals with the problems involved in our industry today and I wish to elaborate upon this as well as upon the tax bill as approved by the House of Representatives.

During the last 8 months, housing starts in the United States have dropped from 1,900,000 to 1,340,000 - a 35% drop. Because of this drop in production, vacancies in apartments, especially in the low and moderate rent range, are almost nil at the present time. Our national housing goal was set at 2.6 million units by the Housing Act of 1968, which this Congress enacted.

The Douglas Commission on Urban Problems, the Kaiser Committee on Urban Housing, and the Joint Economic Committee, as recently as April of this year, have recommended that added incentives be granted the housing industry to stimulate construction of single and multi-family residences. In the face of this, the pending tax reform bill would bring a sharp reduction in starts of multi-family residential construction as well as rent increases for many American families.

This further reduction will be brought about because the returns to equity capital will be so greatly impaired by this law as to reduce capital investment in apartments. It would tend to flow to mortgages, bonds, and other forms of investment, which generally provide more yield without corresponding risk.

Real estate, being a non-liquid asset, is not looked upon with favor by equity investors as a desirable form of investment. It takes the tax incentives which are currently provided to stimulate this type of development.

The National Apartment Association recommends that H.R. 13270 be amended to retain the 150% declining balance method of depreciation on used apartments. The straight-line method is unrealistic in the light of the long useful lives which the Treasury has insisted upon, lives which do not reflect technological obsolescence. So unrealistic is the straight-line method, that denial of the 150% method will seriously limit the resale market thereby discouraging the development of new multi-family projects. The July 24th cut-off date has already had a serious impact by discouraging investors from purchasing apartments!

Our Association strongly objects to the harsh recapture provision in the House bill which would tax all the gain on the sale as ordinary income to the extent of the depreciation taken in excess of straight-line. <u>No attempt is made to differentiate between the short-term holder and the long term investor; certainly, this underscores the unreasonableness of this provision</u>. Our Association recommends instead that during the first five years of the holding period the depreciation taken in excess of straight-line be taxed as ordinary income but thereafter the percentage of gain taxed as ordinary income be reduced 1% per month. Certainly, one who holds property more than thirteen years should be entitled to have all his gain taxed at capital gains rates.

We further recommend that in view of the desire of our government to stimulate more housing, re-examination of the limited tax preference penalties on real estate be examined.

The limit on tax preferences (LTP) was originally devised to prevent high income persons from escaping taxation. As it has now been watered down, hobby farming may escape it by the use of accrual method of accounting; oil is exempted from it; the bulk of the income from municipal bonds is exempted, the Treasury has recommended elimination not only of any reference to state and municipal bonds but also the appreciated value of assets donated to charity. Thus, the prime target of this area now turns out to be real estate, the one area in our economy which can stand the least the cut-back which would inevitably result from the provisions in the House-approved bill. While our economy grew at a rate in excess of 5% in the last 8 years and capital investment grew at a rate of almost 10%, housing starts grew at a rate of only 1/2 of 1%. If we do not stimulate housing, we will find a situation in which the shortages will be further compounded, in which rents will then be forced to rise because of lack of supply. This will cause extreme dislocation to our economy and will produce more people in need of subsidized housing which is just the opposite of our national goal. Our goal should be an increase of supply through tax incentives, if necessary, rather than a reduction through elimination of existing incentives.

Retention of existing law will hold down rental increases throughout the country except to the reasonable extent made necessary by increases in construction costs land costs, and interest charges without the added problem of a market which has imbalance on the demand side which is now occuring.

It is indeed strange that real estate which had the least amount of claimed escape in dollars and the various problem areas presented by the Treasury Department

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has received the greatest amount of penalty at a time when all segments of government feel that housing needs the greatest incentive. We feel that your amending this legislation will enable us to accomplish our goal of providing adequate housing for all American families in the years to come.

Because of the limitation of time on this presentation I respectfully request that the balance of my statement be incorporated in the record.

The Multi-Family Residential Real Estate Industry

(a) Scope of the Industry. Multi-family residential real estate is a billion dollar industry in the United States. As of the end of 1968 there were 68,000,000 housing units in the United States, including both multi-family and single family units. The number of multi-family units (5 or more units under one roof) added annually over the past few years is as follows:

1966	345,700
1967	392,200
1968	548,800 (Value: $7,300,000,000)

The apartment industry employs an enormous number of construction workers, consumes a huge amount of construction materials and employs many additional personnel as managers and operators of apartment projects.

The apartment industry is one of the significant areas in the American economy where the small businessman is a key factor. The typical apartment builder is a small businessman. Past experience has demonstrated that events having an adverse effect on the apartment industry (such as expensive or unavailable financing) not only have a serious effect on the tenant (Housing shortages and higher rents) and the apartment industry as a whole but have a particularly serious effect on the small builder. Big builders can ride out these problems. Small builders often cannot.

(b) Typical Example of an Apartment Project. In order to illustrate the applicability of the tax provisions involved to a typical apartment project, let me set forth an example of a typical residential project within my own experience. The figures on page 5 use a hypothetical 6% mortgage such as might have been obtained 2 or 3 years ago; the figures on page 6 use the actual 7 1/2% mortgage committed for last summer. (Such a mortgage today would carry an interest rate of at least 8 1/2%.)

81 UNIT APARTMENT PROJECT

Land	$175,000	Mortgage	$750,000
Building	825,000	Equity	250,000
Total	$1,000,000	Total	$1,000,000

First Year
(Figures are rounded)
6% Mortgage
8% Constant #

		Occupancy			
		100%	95%	90%	80%
1.	Gross Annual Income	$160,000	$152,000	$144,000	$128,000
2.	Operating Expenses (not including debt service)	64,000	64,000	64,000	64,000
3.	Net Income (before debt service)	96,000	88,000	80,000	64,000
4.	Interest on First Mortgage	45,000	45,000	45,000	45,000
5.	Net Income (after interest deductions)	51,000	43,000	35,000	19,000
6.	Depreciation (40 years, DDB)	41,250	41,250	41,250	41,250
7.	Taxable Income (5 less 6)	9,750	1,750	(6,250)	(22,250)
8.	Mortgage Amortization	15,000	15,000	15,000	15,000
9.	Cash Flow (5 less 8)	36,000	28,000	20,000	4,000
10.	Return on Equity	14.4%	11.2%	8%	1.6%

\# Annual payments of principal and interest equal 8% of the original principal amount of the mortgage loan.

81 UNIT APARTMENT PROJECT

Land	$175,000		Mortgage	$750,000
Building	825,000		Equity	250,000
Total	$1,000,000		Total	$1,000,000

First Year
(Figures are rounded)
7 1/2% Mortgage Plus 2 1/2% of Gross*
9.1% Constant #

		Occupancy			
		100%	95%	90%	80%
1.	Gross Annual Income	$160,000	$152,000	$144,000	$128,000
2.	Operating Expenses (not including debt service)	64,000	64,000	64,000	64,000
3.	Net Income (before debt service)	96,000	88,000	80,000	64,000
4.	Interest on First Mortgage	56,250	56,250	56,250	56,250
5.	Net Income (after interest deductions)	39,750	31,750	23,750	7,750
6.	Depreciation (40 years, DDB)	41,250	41,250	41,250	41,250
7.	Taxable Income (5 less 6)	(1,500)	(9,500)	(17,500)	(33,500)
8.	Mortgage Amortization	12,000	12,000	12,000	12,000
9.	Cash Flow (before mortgagee share)	27,750	19,750	11,750	(4,250)
10.	Less: 2 1/2% gross*	4,000	3,800	3,600	3,200
11.	Cash Flow	23,750	15,950	8,150	(7,450)
12.	Return on Equity	9.5%	6.5%	3.3%	Negative

* The lender receives 2 1/2% of the gross revenue as additional interest over and above the 7 1/2%.

\# Annual payments of principal and interest equal 9.1% of the original principal amount of the mortgage loan.

The foregoing example illustrates a number of points which are typical of multi-family real estate:

(1) The net return to the investor is very sensitive to changes in occupancy. A drop from 95% occupancy to 80% occupany reduces an 11.2% return with a 6% mortgage to 1.6% and reduces a 6.5% return with the 7 1/2% mortgage to a cash loss of $7,450.

(2) The net return to the investor is also very sensitive to financing changes, shifting from a 6% to the 7 1/2% mortgage drops the return at 95% occupancy from 11.2% to 6.5% and at 90% occupancy from 8% to 3.3%.

(3) Variations in operating expenses can have a significant effect. For example, 40% of the gross income has been used as the estimate of operating expenses. I know of instances in which actual operating expenses have been higher. Furthermore, when there are vacancies, operating expenses are often even higher because of turnover expenses such as repainting.

(4) From the time land is contracted for until cash flow begins will take a minimum of 18 months to 2 years during which land must be acquired, the site developed, the building constructed and rented. During that period of time, the investor gets no return on his investment and runs the highest risk that something may go wrong which may prevent completion of the project.

(5) If the House-approved bill is enacted without change, the marginal investment (maximum 9.5% return plus some tax benefits) described in the example on p. 6 would be even less attractive, with these results: (1) rents would have to be higher on new projects to justify such an investment and (2) many such projects would not be built, with these further consequences: (a) an increased housing shortage, (b) higher rents on existing projects, and (c) more tenants now in non-subsidized housing would be forced into subsidized housing.

(c) Recent Trends. The Committee will recall the credit crunch of 1966 when it became clear that there was a significant shortage of capital in the United States, one result of which was that interest rates rose sharply in a trend which is continuing. This shortage of capital continues today. The result is and has been hardship for many areas of American business but the heaviest burden has fallen upon the real estate industry which has found sharply increased costs for financing when it was available and that traditional sources of mortgage financing began allocating more funds to areas other than real estate where they could get higher or equal returns on a shorter term basis with less risk, less bother and less administrative expense.

When a recent Wall Street Journal article is headed "Housing Shortage is Worst in 20 Years, Survey Finds," (3/7/69) if the tax provisions are to be modified they should be made more favorable to real estate investment.

(d) Capital Supply. Funds for the acquisition of land and construction of apartments come from two sources, funds lent by mortgage lenders and risk equity capital put up by investors. The apartment industry competes with all other industries in the United States for capital funds. When bonds of good publicly traded corporations, which are readily marketable and salable on a day-to-day basis and which are commanding returns as high as 7% are available, many funds which would otherwise flow into real estate mortgages at 8% or 8 1/2% will instead flow into these corporate obligations. Similarly, when investors who might otherwise invest in real estate equities get returns of 7% - 8% on corporate obligations and 8% on first mortgages which have substantially less risk than equity capital, funds tend to shift away from equity investment. Without the risk capital of the equity investor it is not possible to build apartment units. Present financial trends in the United States have combined to cause a slow down in the flow of both mortgage funds and risk equity capital to the apartment industry thereby holding back needed apartment construction.

What does the risk capital equity real estate investor obtain for his investment? To attract this capital today when he could get an 8% return on a first mortgage and a 10 or 11% return on a commercial real estate investment the equity investor in apartment projects is looking for a 12% or better cash return on his investment. At the same time, it should not be overlooked that the owner of an equity interest in an apartment project has a non-liquid asset. It is not traded on an exchange or over the counter. It may or may not be readily salable. When things are going well, when apartments are full, when vacancies are low, when rental income is adequate in relation to operating costs, when apartments have waiting lists, then equity interests in apartments can be sold relatively easily. However, as any of these factors start to soften, the situation changes sharply and in years when the operating costs have increased much more sharply than rents have increased, when financing costs and real estate taxes have increased more than rents have increased or when significant vacancies develop, the real estate investor finds that his investment is either not salable or salable only at a loss. The non-liquid nature of the investment significantly increases the risk.

Fortunately, under the tax laws equity investors in real estate find tax benefits which have helped to attract the risk equity capital which has made possible the construction of the apartment units which have been built over the last several years. Given the serious disadvantages which real estate has in raising capital as compared to other forms of capital investment, if these rules were changed adversely to real estate it would be even more difficult to obtain capital and fewer units would be built, with serious adverse consequences not only to tenants seeking housing but also to the many persons employed in the construction of apartments. Some of the large corporations engaged in building apartments would still be able to withstand these trends, but the typical small builder of apartments would not. In our considered opinion the elimination of accelerated depreciation on new construction and elimination of the 150% method on existing apartments would result in a sharp cut back of rental housing with a serious housing shortage as well as increased rentals as an inevitable consequence.

The Residential Housing Supply and Taxes

(a) The Housing and Urban Development Act of 1968. §1601 of the Housing and Urban Development Act of 1968 provides:

> "The Congress finds that the supply of the Nation's housing is not increasing rapidly enough to meet the national housing goal, established in the Housing Act of 1949, of the 'realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family'. The Congress reaffirms this national housing goal and determines that it can be substantially achieved within the next decade by the construction or rehabilitation of twenty-six million housing units, six million of these for low and moderate income families."

In 1968, 1,500,000 housing units were produced and it is estimated that 1,600,000 to 1,700,000 will be produced in 1969. Accordingly, under the present system we are already falling a 1,000,000 units a year short of the national goal for the current period. Actual production of housing units is only approximately 60% of the national goal.

Of the national goal of 2,600,000 units per year 600,000 units are to be low and middle income housing and 2,000,000 other housing. Not only are we not achieving the goals with respect to production of low and middle income housing but we are far short of achieving the overall goal of total housing units. The current financial and capital picture as indicated above is such that the outlook does not look good for the future in terms of expanding the units produced, even if the present tax rules are left the way they have been for 15 years. We believe that when other Federal laws are being designed to encourage housing production, it would be unsound public policy to change the tax rules to make real estate investment less attractive.

(b) National Commission on Urban Problems (Douglas Commission). The National Commission on Urban Problems, chaired by former Senator Paul Douglas, has made an extensive study of urban problems including housing. One of its statutory assignments was a study of "tax policies with respect to their effect on land and property cost and on incentives to build housing and make improvements in existing structures."

Federal taxation as it relates to housing is discussed in Chapter 7, "Federal Income Taxation and Urban Housing" which is contained in Part IV of the Report, Investment Structure, Finance and Taxation.

The Commission concluded (p. 7-10):

> "(1) That special tax preferences should not be relied upon as the sole or even the primary instrument to deal with urban housing problems;
>
> (2) That, however, some changes in Federal income tax laws and regulations should be made as soon as possible; and
>
> (3) That there should be vigorous official exploration of certain other potentially significant changes that might improve the tax climate for urban housing."

The Commission also stated (p. 7-10):

> ". . .[o]ur special concern here is with the effect of present arrangements upon incentives for investment in housing, and it seems clear (1) That existing tax provisions have been 'institutionalized' into a complex set of economic relationships that involve a large volume of investment as well as the provision of rental housing for about one-third of all American families; and (2) That any 'loophole-closing' efforts, if applied only or more strenuously to this than to other competitive investment fields, would probably curtail the flow of resources and managerial efforts into this area. . . ."

The Commission made three recommendations (Report. part IV, Investment Structure, Finance, and Taxation, chapter 7, "Federal Income Taxation and Urban Housing", pp. 7-20 - 7-22):

1. The Commission recommends that the President direct the Treasury Department to make an intensive analysis and submit explicit findings and recommendations concerning tax law changes best suited to provide materially more favorable treatment for investment in new residential construction (including major rehabilitation) than for other forms of real estate investment.

2. The Commission recommends that the Internal Revenue Code be amended to provide specific incentives for adequate maintenance and rehabilitation of rental residential property by allowing, within appropriate limits, for especially generous tax treatment of investor-owners' expenditures for these purposes with respect to structures of more than some specified age, such as 30 or 40 years.

3. The Commission recommends prompt revision of the Federal income tax laws to provide increased incentives for investment in low- and moderate-income housing, relative to other real estate investment, where such housing is governmentally subsidized and involves a legal limit upon the allowable return on investors' equity capital. Specifically, we propose that the Internal Revenue Code be amended to provide especially favorable treatment (whether through preferential depreciation allowances or through investment credits) for investments made under governmentally-aided limited-profit programs for the construction and rehabilitation of low- and moderate-income housing.

We endorse the three recommendations of the Commission. If our national housing goals are to be met, new incentives must be found for new residential construction. Special incentives are also appropriate for low and middle income housing. It seems to us that the investment credit is a tested method of tax incentive through which this incentive for low and middle income housing could be provided.

(c) The President's Committee on Urban Housing. On December 11, 1968 the President's Committee on Urban Housing under the chairmanship of Edward F. Kaiser submitted its final report. This Committee had submitted various reports from June of 1967 to that date and made recommendations which became part of the Housing and Urban Development Act of 1968.

One of the major goals which the Committee seeks to reach is to encourage new investment in low and middle income housing. This was one of the purposes of the National Housing Partnership established by the Housing and Urban Development Act of 1968. To reach this goal the Committee relies heavily on tax incentives.

This point can be illustrated by the Kaiser Committee's discussion of §221(d)(3) of the National Housing Act. Under that provision a profit sponsor can be set up on a limited dividend basis, can obtain a 90% mortgage insured by FHA, but is limited to a net cash return of 6% on the 10% equity. The report points out that this return is so low that it would not be at all attractive to investors without the Federal income tax benefits under existing law. Furthermore, even with the current tax benefits under existing law the yield is made substantially more disadvantageous by the existing provisions taxing gain on sale (as long term capital gain except to the extent of ordinary income arising from the recapture of depreciation rules of §1250). Table 2-6 shows yield in relation to tax bracket, disregarding tax on sale. Table 2-7 shows how the yield is reduced because of the tax on gain on sale.

(See Page 14 for Tables 2-6 and 2-7)

Kaiser Committee Report Page 83:

TABLE 2-6. Cumulative Average After-Tax Yield—(Including 6 Percent Cash Return and Tax Saving) on Investment of $408,000 [1] (221(d)(3) Below Market Interest Rate Project) for Investors in 30, 50, and 70 Percent Bracket Ignoring Tax Consequences on Sale

Years before sale [2]	Yield for taxpayer 30 percent bracket			Yield for taxpayer 50 percent bracket			Yield for taxpayer 70 percent bracket		
	Annual return [3]	Dis [4]	Average [5]	Annual return [3]	Dis [4]	Average [5]	Annual return [3]	Dis [4]	Average [5]
		Percent	Percent		Percent	Percent		Percent	Percent
1	$77,000		18.9	$128,300		31.4	$179,600		44.0
2	38,600	14.5	14.2	64,000	24.4	23.6	90,100	37.7	33.1
3	49,800		13.5	66,600		21.1	83,400		28.8
4	46,900		13.0	61,800		19.7	76,700		26.3
5	44,100	12.9	12.6	57,200	19.9	18.5	70,200	27.4	24.5
6	39,700		12.1	49,900		17.5	60,000		22.8
7	37,100		11.7	45,500		16.6	54,000		21.5
8	34,600		11.3	41,400		15.8	48,200		20.3
9	32,200		10.9	37,400		15.0	42,500		19.2
10	29,900	11.3	10.5	33,500	16.8	14.4	37,000	23.2	18.2
11	27,600		10.2	29,700		13.7	31,700		17.2
12	25,400		9.9	26,000		13.1	26,600		16.3
13	23,300		9.5	22,400		12.5	21,600		15.5
14	21,200		9.2	19,000		12.0	16,800		14.7
15	19,200	10.2	8.9	15,600	15.0	11.4	12,100	21.2	13.9
16	17,200		8.6	12,300		10.9	7,500		13.1
17	15,300		8.3	9,100		10.4	3,000		12.4
18	13,500		8.1	6,000		9.9	(1,400)		11.7
19	11,600		7.8	2,900		9.4	(5,700)		11.0
20	9,800	9.4	7.5	(100)	13.8	8.9	(9,900)	20.0	10.3

[1] If real equity is less than $408,000, yields would increase proportionately. Assumes that return is received annually, and that entire equity investment must be made at the beginning of construction.
[2] Assumes one-year construction period and one year break even period.
[3] "Annual return" is the sum of Columns A (net cash income) plus applicable Column B, C, or D (tax savings) in the table in Appendix H-2.
[4] "Dis" represents the average cumulative rate of return on the $408,000 equity, discounted in accordance with accepted financial practice.
[5] "Average" represents the average cumulative rate of return on the $408,000 equity, not discounted.

Kaiser Committee Report Page 84:

TABLE 2-7. Effect of Tax on Sale [1] of 221(d)(3)BMIR Project on Yield [2]
Taxpayer in 50 Percent Tax Bracket

	After tax rate of return before sale [3] in percent		After tax rate of return after sale [4] in percent	
	Discount	Average	Discount	Average
Sale after 2 years	24.4	23.6	3.3	3.3
Sale after 5 years	19.9	18.5	5.8	4.5
Sale after 10 years	16.8	14.4	9.7	5.6
Sale after 15 years	15.0	11.4	10.7	4.7
Sale after 20 years	13.8	8.9	11.0	3.5

[1] The sale price is assumed equivalent to the unamortized mortgage amount which would be outstanding had the project initially received 100 percent mortgage financing.
[2] If real equity is less than $408,000, yields would increase proportionately.
[3] See Table 3-4.
[4] Table 3-4 yields reduced by tax consequences of sale See Appendix H-3.

Accordingly, the report concludes that existing tax provisions are not sufficiently beneficial to the investor to make the project sufficiently attractive and recommends that either the tax to be paid on sale should be added to the sale price which FHA can recognize in the case of a sale of a project to a cooperative condominium or non-profit organization, or that a 3% tax credit of the total replacement cost of the project be provided as an additional incentive or that the tax laws be amended to limit the taxable gain on sale to the amount by which the sale price exceeds the original value of the project, that is equity plus original mortgage. This last approach would mean that there would be no recapture, even at capital gain rates, of depreciation deductions. In other words, the Kaiser Committee concludes that many of the existing tax rules are an important affirmative incentive for investment in low- and middle-income housing, but that some of the existing tax rules discourage such investment.

(d) The Treasury Study. Under date of February 5, 1969, there was published a three volume document of the Treasury Department entitled "Tax Reform Studies and Proposals" (herein called Treasury Study). While it contains a large number of proposals involving changes in many areas of the Code, no proposals are made with respect to accelerated depreciation (or for that matter with respect to real estate) except for the proposal with respect to Subchapter S which is discussed below. (pp. 29-30)

Treasury made extensive recommendations in 1961 and 1963 with respect to real estate (which were rejected totally by the Congress in the 1962 Revenue Act and were substantially rejected by the Congress in the 1964 Revenue Act). We think it is significant that after four more years of study by Treasury, including contract studies by economists at the University of California (Treasury Study, p. 451), Treasury made no recommendations. Incidentally, we think the results of the study by the California economists should be made public.

The Treasury Study stated the impossibility of making reliable quantitative estimates of the effect of the tax laws on construction and housing supply in the present state of the economic art. (p. 442). It will be recalled that the Douglas Commission expressed concern that restrictive changes in the existing institutionalized tax provisions would curtail the flow of resources and managerial efforts into housing (see p. 11 above).

In part three of the Treasury Study from pages 438 through 458 under the heading IX C SUPPLEMENTARY MATERIAL: TAX TREATMENT OF REAL ESTATE there appears a good bit of material in connection with real estate taxation, but there are no recommendations.

The Treasury Study is devoted solely to the tax effects of current law on real estate situations and does not consider the influence of these tax factors on the housing supply. Both the National Commission on Urban Problems (the Douglas Commission) and the President's Committee on Urban Housing (the Kaiser Committee) considered not only the tax provisions but the effect of the tax provisions on the housing supply. Both of these reports recommend adding additional incentives in certain areas of housing and do not recommend any restrictive changes in any of the existing real estate tax provisions. We think it is highly significant that two independent studies which were concerned with the total picture (the relationship of the tax provisions to the housing supply) and were not concentrating solely on the tax aspects alone have come to two general conclusions which are the same, although some of their specific proposals differ:

(1) No change adverse to the real estate investor should be made in the existing rules;

(2) Additional tax incentives in certain areas of real estate are desirable.

The Treasury Study (pp. 451 - 458) sets forth figures with respect to (1) 14 real estate operators, (2) 19 real estate investors and (3) 17 real estate owners who sold real estate. The figures given do not indicate that the combination of tax losses and cash profits which resulted in many of these instances were the product of accelerated depreciation rather than other factors, such as itemized deductions and the deduction for long term capital gain. Furthermore, these figures relate to only a few taxpayers selected by the Treasury out of the thousands of returns analyzed by its statisticians.

We believe that it would be an enormous mistake to make basic changes in the tax provisions affecting real estate in order to take care of a situation involving a few taxpayers. The information furnished by the Treasury Department in the Treasury Study does not justify across-the-board changes which would adversely affect hundreds of thousands of taxpayers.

The Treasury Study (p. 442) estimates the revenue cost of accelerated depreciation for residential real estate (apparently including both 150% declining balance and other accelerated depreciation) at $250,000,000 broken down (1) $100,000,000 for older housing, (2) $100,000,000 for semi-luxury and luxury high rise construction and (3) $50,000,000 for low and moderate income housing. Presumably, the second category, although labelled "semi-luxury and luxury high rise" must also include middle income garden apartments, since they do not fit in either of the other categories.

Existing Tax Discrimination Against Real Estate

There are two important respects in which the current tax rules discriminate against real estate, the first involves the area of useful lives and the second relates to the investment credit.

Useful Lives

In 1962 when the Treasury Department published depreciation guidelines, Rev. Proc. 62-21, 1962-2 C.B. 418, the useful lives contained therein substantially lowered the useful lives of depreciable assets contained in Bulletin F except in the case of real estate other than farm real estate:

	Bulletin F (Good-average construction)	Guidelines	Change in Useful Lives
Apartments	40	40	No change
Farm Buildings	50	25	100% reduction
Office Buildings	40-45	45	Increase

The Treasury position was that unless there were to be full ordinary income recapture of real estate depreciation the useful lives would not be shortened.* We believe that it is wrong in principle to deny real estate fair and appropriate useful lives merely because Treasury has been unable to persuade Congress to change the tax laws in another respect which has nothing to do with useful lives.#

Many examples can be given to illustrate the incorrectness of the guidelines lives: for example, apartment projects built 10 or 15 years ago without swimming pools and/or without air conditioning are today obsolescent and are unable to compete economically with newer projects. Consider the many apartment projects built after World War II under §608 of the National Housing Act, most of which are today obsolete.

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* "Since no action was taken by the Congress to provide recapture of excess depreciation on real estate, the administrative revision of depreciation guidelines in 1962 was confined, in effect, to personal property. While guideline lives were provided for buildings, they were essentially the same as those in Bulletin F with the exception of farm buildings." (Treasury Study page 447)

\# An administrative problem which needs to be improved is persistent re-examining by revenue agents of useful lives and changes in useful lives just 2 or 3 years after another agent, in an extensive examination, has adjusted useful lives. I know of a case where the present agent is trying to increase lives from 30 to 60 years where another agent established them just a few years ago. This has the effect of repealing double declining balance depreciation by revenue agent action.

Accelerated Depreciation

Section 167(a) of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of income producing property. A substantially similar provision has been in the Code since the Revenue Act of 1913.

With respect to short-lived assets straight line depreciation often represents an economically appropriate reasonable allowance for depreciation. In the case of long-lived assets, such as apartment buildings, straight line depreciation would not cause a proper reflection of annual income where the property is held for many years. In the early years there is realistically a larger annual charge for depreciation (especially for obsolescense) as compared to later years. Accordingly, accelerated depreciation is appropriate for real estate. This fact has been continually recognized administratively by the Internal Revenue Service for twenty three years.

Without benefit of specific statutory authority referring to the use of a declining balance method of depreciation, as early as 1927* the Internal Revenue Service recognized the existence of such method. Since 1946#, the Internal Revenue Service has recognized that a reasonable allowance for depreciation includes depreciation computed on the declining balance method. In a private ruling in 1946, the Internal Revenue Service approved 150% declining balance depreciation for buildings.[o]

* I.T. 2369, VI-2 C.B. 63 (1927)

\# I.T. 3818, 1946-2 C.B. 42

o/ Special ruling, August 30, 1946, 4 CCH 1946 SFTR 6273

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In the Internal Revenue Code of 1954 additional accelerated depreciation was extended by statute to new property, including buildings,# up to a maximum of 200% declining balance. The Committee Report,o/ Regulationsoo/ and a published ruling*/ recognize that 150% declining balance had been available under prior law.

In 1964, in response to Treasury criticism that there was a tax abuse where taxpayers took accelerated depreciation and then disposed of the property in a relatively short time, the Congress enacted §1250 which provides recapture of all or some real estate depreciation, varying with the holding period of the asset. §1245 provides total recapture of depreciation for machinery and equipment, unrelated to holding period. Unlike machinery and equipment, real estate is (A) long-lived, not short-lived and (B) owned to a significant extent by individuals subject to sharply progressive income tax rates (14 to 70% without the surcharge). Thus, the §1245 treatment which applies to relatively short-lived assets substantially owned by corporations is inappropriate for real estate.

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o/ "Under this method [the declining balance method] a uniform rate is applied to unrecovered basis of the asset. Since the basis is always reduced by prior depreciation, the rate is applied to a constantly declining basis. The salvage value is not deducted from the basis prior to applying the rate, since under this method at the expiration of useful life there remains an undepreciated balance which represents salvage value. The rate to be used under this paragraph may never exceed twice the rate which would have been used had the deduction been computed under the method described in paragraph (1). Under section 23(l) of the 1939 Code the declining balance method was allowed in certain instances but the rate was generally limited to one and one-half times of the rate used under the straight-line method. If this method has been used for property acquired prior to December 31, 1953, it may continue to be used but the rate provided for in paragraph (2) will not be presumed to be reasonable with respect to such property. . . ." H. Rept. No. 1337, 83d Cong., 2d Sess. (1954), p. A48. (As is noted, accelerated depreciation also avoids the salvage value controversy and never results in deductions in excess of basis, which is generally cost).

oo/ Reg. §1.167(b)-0(b)

*/ Rev. Rul. 57-352, 1957-2 C.B. 150

#/ See H. Rept. No. 1337, 83d Cong., 2d Sess. (1954), p. 23; The 200% declining balance method was provided by the 1954 Code for "rental housing and industrial and commercial building" as well as machinery and equipment.

The Treasury Study contains no information on what the experience has been under §1250, which has now been in effect over five years.

The term accelerated depreciation is often used to refer to any depreciation in excess of straight line. In the interest of clarity of thinking, two different kinds of accelerated depreciation need to be distinguished, the accelerated depreciation up to 150% declining balance administratively recognized by the Internal Revenue Service for 23 years as being a reasonable allowance for depreciation and the special accelerated depreciation added by statute in the Internal Revenue Code of 1954 for new property up to 200% declining balance.

An apartment is never worth more <u>physically</u> than on the day it opens its door. Thereafter, its equipment is old and it is subjected to falling behind in the development of the art. Refrigerator sizes become larger, air conditioning is introduced, swimming pools are added, new types of carpet come in. The constant changes in equipment and furnishings for an apartment are such that any apartment in the first few years of its life suffers substantially more than straight line depreciation as a matter of economics. This can be illustrated many ways. For example, new apartments tend to have dishwashers; older apartments do not. The cubic foot area of refrigerators has expanded substantially over the years. Projects which are ten years old may have 6 cubic foot refrigerators whereas projects which are being done now have 12 or 15 cubic foot refrigerators. A person looking for a new apartment will naturally tend to prefer one which has the larger capacity refrigerator and a dishwasher. The older apartment project is at a significant competitive disadvantage as compared to the new project.

In the current economy depreciable real property which has been held for many years is often sold at a gain. It is incorrect to assume that this gain demonstrates that the depreciation was excessive. To the contrary, the gain is generally the product of either or both inflation* of the price level and increase in the value of non-depreciable land which is a clear capital gains.

The Treasury Study argues that present tax laws encourage frequent turnover of properties and, therefore, cause inadequate maintenance. (page 443) This conclusion appears to rest on two assumptions: (1) the owner who is holding the property for a longer period will maintain the property well; and (2) the owner who is holding the property for a shorter period will not maintain his property well. Both assumptions are incorrect. The ultimate test of the quality of a property is how it fares on sale in the market place. It is precisely the owner who is going to sell who must maintain his property; if he does not, he will either be unable to sell or he will have to take a substantial discount because of poor maintenance. It is precisely the owner who is going to hold for a long time who can skimp on maintenance, doing only enough to keep tenants minimally satisfied.

For these reasons we urge the Committee to amend H.R. 13270 to retain the 150% method for existing apartments, and to modify the harsh recapture provision in accordance with the recommendation made on pages 1-2 of this statement.

* It was for this reason that this Committee, in 1962, decided not to act on a Treasury recommendation for full recapture of real estate depreciation ". . . Your Committee decided not to apply this treatment to buildings or structural components of buildings at this time because testimony before your Committee indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period. . ." H. Rept. No. 1447, 87th Cong., 2d Sess. (1962), p. 67.

September 26, 1969

STATEMENT CARTER L. BURGESS
NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS
BEFORE SENATE FINANCE COMMITTEE
ON H.R. 13270

Summary

Private investment in the development of low and moderate income housing currently depends upon aid provided through both the existing federal income tax treatment of real estate and the federal housing subsidy programs. The changes in present tax law contained in H. R. 13270 will eliminate much of the incentive for equity investment in low and moderate income housing and substantially reduce entrepreneurial interest in this housing.

Although the bill recognizes a distinction between new housing and other real estate development, it jeopardizes the Congress's efforts to promote the private development of publicly assisted housing and the sale of such housing to low and moderate income tenants and tenant-oriented organizations.

Significantly, this comes at a time when the nation faces its greatest housing shortage since the immediate post-war years and when the demand for housing by lower income families is particularly acute.

In the Housing Act of 1968 Congress established the goal of the construction or rehabilitation of 26 million housing units, including 6 million publicly assisted units, by 1978. If Congress wishes to achieve these goals, it must not eliminate these tax incentives -- at least until it provides a suitable substitute. Since the existing incentives have barely been effective, if private, rather than direct governmental action is to produce decent low and moderate income housing in volume, Congress should, at a minimum, create a new stimulus to development.

It is suggested that H. R. 13270 be amended to provide that upon the sale of a publicly assisted low or moderate income housing project to or for the benefit of persons of low and moderate income, the seller would recognize gain for federal income tax purposes only to the extent

that the amount realized on such sale exceeds the cost as determined under Section 1012 of the Internal Revenue Code. Such action by the Committee would maintain or increase the continued interest of private enterprise in the development of low and moderate income housing without any significant loss of revenue and without disturbing the other goals sought to be achieved by the Tax Reform Act of 1969.

STATEMENT CARTER L. BURGESS
NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS
BEFORE SENATE FINANCE COMMITTEE
ON H. R. 13270

September 26, 1969

Mr. Chairman and Members of the Committee:

My name is Carter L. Burgess. I submit this statement as Chairman of the National Corporation for Housing Partnerships. The Corporation was established pursuant to Title IX of the Housing and Urban Development Act of 1968 as a method of involving American industry more substantially in the national effort to increase the quantity and quality of housing for low and moderate income families.

The Tax Reform Act of 1969, H. R. 13270, substantially modifies current provisions of the Internal Revenue Code related to housing production.. In these respects, the Bill jeopardizes Congressional efforts, built upon the combination of federal tax incentives and subsidies, to promote the private development of low and moderate income housing and the sale of this housing to tenants and tenant-oriented organizations. Unless an effective and suitable substitute is adopted, the Corporation opposes the introduction of several of these new provisions.

<u>National Housing Needs</u>

In the Housing Act of 1968, Congress found that its promise of a generation ago to achieve the goal of a decent home and a suitable living environment "...has not been fully realized for many of the nation's lower income families." To fulfill this obligation and to meet the growing demand for housing, the 1968 Act set a national goal for the next decade of "...the construction or rehabilitation of twenty-six million housing units, six million of these for low and moderate income families."

In the year that has passed since the establishment of the national goals, the production of housing, especially low and moderate income housing, has decreased and today the nation faces one of the greatest housing crises in its history. Under the twin pressures of faltering production and rising family formations, vacancy rates have declined sharply.

Mortgage money is limited and its cost is high. Savings flow away from the traditional institutions that finance housing. Costs of land, labor and materials keep spiraling. And, most important, the equity, or "risk" capital, needed to generate housing production grows scarce, especially for publicly assisted housing. As a result, housing starts by year-end may fall below the one million level for the first time since 1946. At current rates of production, the nation will be more than 10,000,000 units short of the 26 million goal.

The need for more multifamily rental housing is particularly acute. Rental housing presently accounts for more than 40% of all housing starts. Heavy demand for this housing is already reflected in rapidly rising rents and falling vacancy rates. In Chicago and New York City, rental vacancy rates, for example, are currently below 1%. Given our very rapid urban growth, and the increasing costs of land, labor and material, multifamily rental housing will continue to gain importance in the national housing market. Of the 20 million unassisted units Congress sought to have built or rehabilitated by 1978, nine million are to be multifamily.

Nowhere is the shortage worse than in the area of low and moderate income housing. Today, 20 million Americans live in substandard, overcrowded dwellings. In sharp contrast to the national average of 15%, the poor pay 35% of their gross income for housing. One out of every eight American families cannot pay the market price of housing with 20% of its income. Yet, in 1969, the first year of the ten-year program, the Department of Housing and Urban Development projects only 135,000 publicly assisted units will be produced as compared to the 225,000 unit goal. Moreover, it is precisely in this field that multifamily rental housing will play its most important role. Of the 6 million publicly assisted new units called for over the next decade, 3,000,000 are to be privately owned, rental units.

Public Incentives for Private Production

Private investment and development has produced almost our entire stock of multifamily rental housing. Congress has determined that in the area of publicly assisted rental housing, the private sector should continue to have the major production responsibility. This was made clear in the Housing Act of 1968. To achieve the goal of 6 million new and rehabilitated homes for low and moderate income families, Congress had a choice between

-- Programs built upon the existing system of private construction and ownership, aided and regulated by the government but operated within the context of existing real property and tax laws, or

-- Programs of direct government construction, ownership and management

The Committees of Congress agreed that the solution to the problem of producing housing for low and moderate income families lay:

-- First, in assisting the poor so they can afford to pay the cost of privately built dwellings, and

-- Second, in increasing the role of the private sector in the development of the housing by strengthening the capacity of the private organizations already involved.

Thus, Congress decided to build on the system it had developed over the years for involving private enterprise in publicly assisted housing programs. In the 1968 Act, Congress adopted programs, like Section 236, that authorize the Department of Housing and Urban Development to make mortgage interest subsidy payments on behalf of lower income families living in rental housing owned by private organizations willing to accept limited cash returns. This program increases the individual family's ability to pay rent for privately produced housing.

The Housing Act of 1968 also enacted new measures intended to facilitate home ownership on the part of low and moderate income families. The statute added several provisions to the National Housing Act permitting the sale of existing publicly assisted rental projects to tenants on a condominium basis, to tenant cooperatives, and to non-profit corporations and associations established exclusively for the purpose of owning and operating low and moderate income housing. This Congressional action reflects the serious need to encourage participation by lower income families in the management and ownership of their housing.

Congress in the 1968 Act declared that in all these new programs as well as in all existing federal housing programs "...there should be the fullest utilization of the resources and capabilities of private enterprise."

Tax Incentives and the National Housing Partnership

The President's Committee on Urban Housing, a group of 18 business, labor and community leaders under the Chairmanship of Edgar F. Kaiser, was commissioned to find ways of attracting the private sector into the development of housing for low and moderate income families. The Committee recommended the creation of the National Housing Partnership as a privately funded, professionally managed instrument that would provide the equity and skills needed to produce this housing in cooperation with local developers and investors.

The Urban Housing Committee analyzed the federal housing programs for low and moderate income families and concluded that a combination of cash distribution and tax savings was essential to private participation in the production of this publicly assisted rental housing. Because the federal housing programs are designed to keep rents low, the amount of cash distribution is limited by law to 6% of the owner's equity investment, if earned. Federal laws oblige the sponsor of this housing to sign a contract fixing rents and requiring government approval of all rent increases. In addition, the government regulates the sale during the first 20 years of ownership, making such investments highly non-liquid and allowing little opportunity for profit from increased real estate values.

As a result of these restrictions, the Committee found that the primary incentive for private investment in publicly assisted rental housing has been the tax savings generated as a result of the book losses arising from accelerated depreciation. This tax loss can be used to offset other taxable income of a corporate owner or, in the case of a partnership, of the individual partners. The result is a savings in tax dollars varying with the taxpayer's individual tax rate.

The Committee on Urban Housing also reported that the current tax consequences of sale of such projects, particularly those providing for recapture of certain depreciation under existing Section 1250, seriously diminish the attractiveness of investment in this housing and impede efforts to facilitate purchase of projects by low or moderate income tenants or their organizations.

Consequently, in proposing the National Housing Partnership, the Urban Housing Committee emphasized that "...the financial feasibility of the proposal is based upon existing real estate practice and tax laws."

The Committees of Congress that reported the 1968 Housing Act also expressly recognized that the existing tax treatment of real estate, including provisions for accelerated depreciation, was essential to the financial feasibility of the National Housing Partnership and other private businesses organized to develop low and moderate income housing. The Report of the Senate Banking and Currency Committee acknowledged the importance of tax savings in attracting equity capital into housing when it authorized the creation of the National Housing Partnership in Title IX of the Act:

> "This title would authorize the creation of federally chartered, privately funded corporations to mobilize private investment and the application of business skills in the job of creating low and moderate income housing in substantial volume. Such a corporation in turn would form a partnership, as its vehicle for participating in developments, projects, or undertakings for the provision of housing primarily for families of low and moderate income, pursuant to Federal programs or otherwise.
>
> "The partnership arrangement makes it possible to assure an adequate return to investors. Under existing Internal Revenue Service regulations and rulings, partnership losses for tax purposes flow to the individual partners. In the case of new housing units financed on a 10-percent equity -- 90 percent debt basis, the annual accelerated depreciation of the building cost results in substantial book losses during the initial ten years after the project is built. Assuming the member of the partnership is in a relatively high income tax bracket, his share of the depreciation losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capital." (Emphasis added)

National Corporation for Housing Partnerships

Pursuant to Title IX, the National Corporation for Housing Partnerships has been established. The Corporation will act as the general partner of the National Housing Partnership and will manage the day-to-day affairs of the Partnership. The limited partners in the Partnership will be corporations seeking a vehicle to invest in low and moderate income housing.

President Johnson chose 15 Incorporators with the advice and consent of the Senate to begin operations. President Nixon asked all of the original Incorporators to continue their task of organizing the Corporation and to work towards completing the initial financing.

The Incorporators have elected me Chairman of the Corporation and and selected Ray Watt as President. Edgar Kaiser serves as Chairman of the Incorporators.

We have organized a small group of experts from business, housing and government to give the Corporation an immediate staff capacity. A line of credit with 15 national banks has been arranged to meet our start-up and organizational requirements. We are currently seeking to raise $50 million of investment capital primarily to provide a portion of the equity needed to build 120,000 rental units for low and moderate income families.

Working with local sponsors, the National Partnership will organize local partnerships and invest the "risk" capital needed for these entities to develop publicly assisted rental projects. We will also provide technical assistance, processing aid, management training and other services to the local partnerships.

Consequences of Tax Reform Act on Production of Publicly Assisted Housing

We believe that the potential corporate and individual investors in the National Housing Partnership and in the local partnerships we will organize, will participate in federal housing programs only if they are able to anticipate a reasonable after-tax return comparable to that available from other investments. Yields from investments in housing are comprised of two parts -- current yield earned while the project is being operated, and the ability to recover investment upon sale. Since current cash flow in publicly assisted housing is limited to six percent of equity before taxes, and since the timing and pricing of sales are regulated, the availability of adequate yields depends upon the tax treatment of accelerated depreciation and sales. The Tax Reform Act of 1969, would amend the tax treatment of accelerated depreciation and of housing sales, drastically reducing the stimulus to the production of publicly assisted rental housing.

The Tax Reform Act would amend Section 1250 of the Code to deny long-term capital gain treatment on the sale of real estate to the extent of all depreciation claimed in excess of depreciation allowable under the straight line method. Further, in the case of individuals, the Bill would treat the difference between the amount taken for accelerated depreciation and that allowable under the straight line method as an item of "tax preference income." The Bill would also allocate certain of a taxpayer's deductions to accelerated depreciation and disallow them. The combined effect of the change in Section 1250 and the other proposals is to reduce the incentive to investment in publicly assisted rental housing very seriously -- particularly for the non-corporate investor.

Studies undertaken for us by the accounting firm of Touche, Ross & Co. considered the effect on after-tax yields of the changes contemplated by H.R. 13270 in Section 1250, as well as the introduction of the limitation on tax preferences and allocation of deductions requirement. The studies show that after-tax yields to hypothetical individual investors in a Section 236 project could be reduced by as much as 1/3 to 1/2. The Touche, Ross & Co. work also demonstrates that the combined effect of amending Section 1250 and increasing the tax rate on the capital gains could reduce after-tax yields to a hypothetical corporate investor upon sale by as much as 15%.

In conventional rental housing this reduction in yields will, as others have pointed out in detail, have the effect of increasing already high rents. But, in publicly assisted housing, where rents and resale are regulated, where the amounts of federal subsidies are limited and where tenants are of the most modest means, there is no way to recoup this reduction and keep investment reasonably attractive. The result is that private investment in such housing will inevitably decline below its already low level. In other words, if H.R. 13270 is passed in its present form, this nation simply will not meet its goals for low and moderate income housing.

The Corporation does not oppose the enactment alone of the limitation on tax preferences and allocation of deductions -- even though they have some adverse impact on yields, particularly if sale occurs in the early years of ownership. We do oppose the amendment of Section 1250 as proposed in H.R. 13270 and point out that the adoption of the limitation on tax preferences and the allocation of deductions as well as the amendment of Section 1250 will seriously impair the development of decent homes for the poor. Unless a suitable and effective substitute is also introduced, we would oppose the change in Section 1250 and the adoption of the other provisions.

Limitation on Tax Preferences

As indicated, the Corporation does not oppose inclusion of accelerated depreciation in the proposed limitation on tax preferences. The Corporation does oppose the proposal advanced by Secretary Kennedy in his testimony of September 4 to include as an item of preference the excess of interest, taxes and rent over receipts from unimproved real property during the period of construction. This amendment would lower yields to an individual investor in all housing, and particularly for low and moderate income units, further than is already contemplated in H.R. 13270.

Amendment of Section 1250

Existing Section 1250 seriously diminishes the yield from investments in publicly assisted rental housing, and discourages sale of this housing to tenants at an early date. In both these respects, it already runs counter to objectives specifically expressed by Congress in the 1968 Housing Act. Yet, Section 521 of the Tax Reform Act would amend Section 1250 to provide for the recapture at ordinary income rates of all depreciation in excess of straight line depreciation upon the sale of the property. Such a change in the tax law would exacerbate an already difficult situation by making the tax consequences of sale of projects to or for the benefit of their tenants still harder to bear.

Consequently, we oppose Section 521 of the Bill unless a substitute measure is adopted permitting investors to sell low and moderate income housing to organizations of tenants on a basis that will allow them to recover their investments after taxes. We are prepared to offer such an alternative.

Recommendation

We suggest that the Committee implement a recommendation of the President's Committee on Urban Housing which would establish a new tax incentive that will directly and meaningfully enhance the production of publicly assisted rental housing. We suggest and we are prepared to support an additional provision in the Bill that would, in the case of an approved sale of a qualified low and moderate income housing project, forgive all tax to be paid on gain from the sale unless the gain exceeded the cost of the project as determined under Section 1012 of the Internal Revenue Code. Any gain in excess of such cost would be taxed at capital gain rates.

Under this proposal, a qualified project would be developed under the assisted housing programs of the federal government and similar state and local programs. A sale would be any sale of a qualified project for the benefit of individuals or families of low or moderate income in accordance with the regulations prescribed by the Secretary of the Treasury. In any event, governmental control of the price and timing of sales would insure that the economic benefit of this provision would inure to the acquiring low and moderate income tenants.

By reducing the tax on disposition of these projects, this provision would lower the regulated sale price of a project. The debt service requirements of the subsequent owning group would also be reduced, permitting it to set and maintain

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low rents. Such sales might be directed to low or moderate income families on a condominium basis, or to a cooperative formed by tenants, or to a non-profit group created for the purpose of owning this housing.

Following a sale to the tenants or to a tenant oriented organization, there will be little or no loss of Treasury revenue on account of depreciation of the project or on account of interest on the purchaser's mortgage. If the sale is made to a non-profit organization, the organization will of course not take any income tax deductions. If a sale is made to tenants themselves, or to a tenant cooperative organization, no depreciation deductions will be allowable because the use of the property by the owner is for a residence. Interest deductions will be allowable, but tenants will be in sufficiently low income tax brackets so that even if they do not elect the standard deduction, the loss of revenue will be slight.

This change in the Bill could be introduced without altering the proposed limitation on tax preferences or allocation of deductions.

The Corporation staff is prepared to discuss the details of this suggestion with the Committee staff at any time.

Before closing, let me point out two further provisions of the Tax Reform Act that we believe require technical clarification.

Hobby Losses

Section 270 of the Internal Revenue Code imposes limitations on so-called "hobby losses" -- individual deductions attributable to the operation or trade of a business that has produced deductions substantially in excess of gross income for a period of five consecutive years. This provision currently has no effect on the Corporation's operations.

Section 213 of the Bill would amend Section 270 to provide that, in the case of individuals, deductions:

> "attributable to an activity shall be allowed only to the extent of the gross income from such activity unless such activity is carried on with a reasonable expectation of realizing a profit."

The House Committee Report states that the purpose of this amendment is to deny deductions in excess of gross income from an activity:

> "where taxpayers are not carrying on a business to realize a profit, but rather are merely attempting to utilize the losses from an operation to offset their other income."

Whether an activity is being carried on with a reasonable expectation of profit will be determined, according to the Committee Report "...on the basis of all the facts and circumstances." The proposed amendment would create a rebuttable presumption that an activity was not being carried on with a reasonable expectation of profit if total deductions allowable with respect to that activity exceed gross income from that activity by $25,000 in three of five consecutive years.

The proposed section might be interpreted to deny to individual investors the right to use tax losses from housing investments to shelter income from other sources. Although few local investors in publicly assisted rental projects in which the Partnership participates would make investments large enough to generate sufficient losses to bring them within the statutory presumption, the Commissioner would be allowed to show the absence of a profit expectation under all facts and circumstances, without regard to the presumption.

It is our understanding that this new provision is not intended to affect real estate but is directed at certain agricultural investments. We suggest that clarifying language be added to make the section clearly inapplicable to investment in low and moderate income housing.

Limitation on Interest Deduction

Section 221 of the Bill amends Section 163 of the Code to limit the amount of "investment" interest that may be deducted by an individual taxpayer in any taxable year to the sum of his net investment income and $25,000. The House Committee Report states that "...interest on funds borrowed in connection with a trade or business would not be affected by this limitation." Rental housing, the Report continues, will be considered trade or business rather than "investment" property if the sum of the deductible business expenses of operating the property equals or exceeds 15% of rental income and the taxpayer is not guaranteed a specified return in whole or in part against loss of income.

Though Section 236 or equivalent projects will always meet these criteria, we suggest that the language be clarified to indicate that such projects would not in any case be considered "investment" property and that interest on mortgage indebtedness incurred would not be subject to the proposed limitation.

Conclusion

The National Corporation strongly supports efforts to bring equity and order into federal tax law. But, we do not understand how Congress could limit the basis for our operations when the Congress itself recognized the importance of this pattern when authorizing Title IX only a year ago. We do not understand how Congress could virtually assure that the national housing goals, which it proclaimed one year ago, will not be attained -- as this is the inevitable consequence of acceptance of all of the provisions in the Bill. We do not believe that fairness and social justice are achieved by abolishing the primary means for attracting the private capital needed to produce decent, safe and sanitary housing for low and moderate income families.

Thank you for the opportunity to present the views of the National Corporation for Housing Partnerships.

TENANT-OWNED APARTMENT ASSOCIATION, INC.

ORGANIZED 1928

99 CHURCH STREET, NEW YORK, N.Y. 10007

TELEPHONE: 732-5200

<u>SUMMARY OF PRINCIPAL POINTS</u>

Statement Presented by

Brewster Ives

September 26, 1969

1) Proposed Section 302, Allocation of Deductions, is an unreasonable attempt to limit allowable deductions because of source of payment. It will cause serious financial reverses to cooperative apartment home ownership and result in further problems for our beleaguered cities.

2) It should be made clear that proposed Section 221, Limitation on Interest, is not applicable to interest on loans taken to purchase or carry cooperative apartments and to the deduction now allowed under Section 216(a)(2), IRC.

STATEMENT OF

TENANT-OWNED APARTMENT ASSOCIATION, INC.

CONCERNING HR 13270

PREPARED FOR PRESENTATION AT A HEARING

OF THE UNITED STATES SENATE

WASHINGTON, D.C.

by

BREWSTER IVES

SEPTEMBER 26, 1969

I appear on behalf of the Tenant-Owned Apartment Association, Inc. which represents 218 buildings and more than 2,200 cooperative apartment owners in the New York metropolitan area. Our Association is devoted to the welfare of cooperative projects and the furtherance of responsible home ownership in urban areas. We wish to comment on Section 302, relating to allocation of deductions, and Section 221, relating to deduction of interest.

Section 302

We do not believe that the treatment provided by Section 302 is proper. As stated in the Report of the House Committee on Ways and Means (Part 1) (at page 82), Section 302 is intended to disallow expenses on the theory, and to the extent, that they may reasonably be assumed to have been met out of tax-free income. The expenses subject to allocation are personal expenses (e.g., medical expenses, interest and real estate taxes in respect of residences) which cannot be considered as costs of earning tax-free income. Hence, a partial disallowance was thought to be appropriate because tax-free income was deemed to constitute the cash source for the payment of these expenses. Consistently with this approach, the disallowance of these expenses under Section 302 is roughly in proportion to the tax-free income.

We respectfully submit that the proposed treatment is improper for two reasons. First, it assumes that the source of payment of the personal expenses in question is solely out of income, and not to any extent out of capital. Since such expenses are not costs of earning income, taxable or otherwise, this assumption is without basis. However, even if it is assumed that the source of payment is solely out of income, this would provide no sufficient reason for disallowance of the expenses, because the source of payment of an expense is irrelevant to its deductibility. Indeed, if Section 302 were enacted, it would constitute the sole example of which we are aware in the entire Internal Revenue Code where the source of a payment determines its allowability as a deduction. Personal expenses

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of the type allocated under Section 302 are not costs of earning income, and have never been so viewed or treated. Such expenses are allowable under the Code irrespective of their personal character. And, as stated above, the source of payment of an expense has no bearing on whether or not it should be allowed. Therefore, proposed Section 302 is without support in reason.

The disallowance of allocable personal expenses under Section 302 is related directly to the amount of the taxpayer's allowed "Tax Preferences". Thus, if the taxpayer has no allowable Tax Preferences, his personal deductions will not be allocated or partly disallowed under Section 302. No policy has been expressed in the House Report for the disallowance of personal expenses as such. Since the amount of disallowance of deductions depends on the existence and amount of allowed Tax Preferences, Section 302 represents, in substance, only a further attack on Tax Preferences. It is respectfully submitted that if a policy to disallow Tax Preferences is to be effected it should be done directly and without relation to personal expenses.

Apart from deficiencies inherent in the basic approach of Section 302, as discussed above, its application to deductions arising from cooperative apartment ownership flies in the face of the national concern to preserve the great cities of this nation in spite of their ever mounting problems. The enumeration of such problems here is unnecessary in view of the attention which they continue to receive by Government, and in the media and literature of our times. The desirability of halting and reversing the seemingly irresistible flight to the suburbs of middle and high income taxpayers, one of the greatest of the problems facing the cities, is both apparent and urgent.

The proposed disallowance under Section 302 of expenses otherwise allowable under Section 216 of the Internal Revenue Code, in connection with cooperative apartment ownership, would substantially aggravate this problem by adversely affecting the tax consequences of cooperative apartment ownership provided under present law. Cooperative apartment tenancy occurs almost exclusively in the cities and such apartments are owned primarily by middle and high income taxpayers. The effect of Section 302 on existing tax deductions available to cooperative apartment owners would result in substantially increased occupancy costs. This would make city living less attractive and stimulate further departures to suburbia. Certainly the continued presence of such residents in the cities, together with that of less affluent persons is highly desirable to maintain a proper balance. In view of continued concern with the urban crisis, legislation which would promote further deterioration of our cities seems most inappropriate.

Section 216 of the Internal Revenue Code of 1954 and comparable predecessor provisions have been included in the Internal Revenue Code since 1942, over 26 years. There can be little doubt that the price and value of cooperative apartments in the market has been importantly affected by available tax allowances and that the elimination thereof in whole or in part will seriously depress such value by increasing net occupancy costs. Furthermore, the pressure caused by resulting sales of cooperative apartments would disrupt the existence of an orderly market, further depressing values. Moreover, it is contrary to our system of laws to enact legislation which would retroactively affect transactions concluded in partial reliance on predictable consequences based on then existing law.

The enactment of Section 302 will arrest the constantly growing acceptance of the cooperative form of urban home ownership. The need for providing acceptable residential accommodations for the middle and upper income segment of the urban population to insure the survival of cities is beyond question. Cooperative home ownership involves these groups in the future of urban centers and helps to preserve the stability of our cities.

SECTION 221 - INTEREST

Under present law, individual taxpayers may deduct interest paid or incurred during the year without limitation on the amount of such deduction. Section 221 would limit the deduction of investment interest to $25,000 in excess of net investment income and long-term capital gains.

The Report of the House Committee on Ways and Means (Part 1) states (at page 72) that interest incurred for purposes such as "a home mortgage" would not be affected by this limitation. No express reference is made, however, with respect to interest attributable to the ownership of a cooperative apartment. To avoid problems of statutory interpretation which might be presented in the future, we believe it necessary to have an expression from this Committee that interest incurred on loans obtained to purchase or carry equity ownership of a cooperative apartment or amounts deductible under Section 216(a)(2) IRC, on account of interest of a cooperative housing corporation, will be similarly treated under this provision. This treatment is consistent with that provided in Section 221 for interest on loans to acquire single family residences, and represents a continuation of the policy first expressed by Congress in 1942 that "...tenant stockholders of a cooperative apartment (be) in the same position as the owner of a dwelling house so

far as deductions for interest and taxes are concerned."
S. Rept. 1631, 77th Cong. 2d Sess. (1942), at page 51.

The statutory language in Section 302 of the Bill indicates that amounts deductible under Section 216(a)(2), IRC, are not intended to be affected by Section 221 of the Bill. This is supported by the fact that new separate subsections 277(c)(1)(A)(i) and 277(c)(1)(A)(vii) are respectively provided for interest under Section 163, IRC, and amounts deductible under Section 216, IRC, including amounts deductible under Section 216(a)(2), allocable to interest of a cooperative housing corporation. The use of such separate provisions in the enumeration of items subject to allocation of deductions under Section 302 clearly indicates that the term "interest" in Section 221 was not intended by the statutory draftsmen to describe amounts deductible under Section 216(a)(2), IRC.

There can be little question that interest incurred to purchase or carry the equity in a cooperative apartment and amounts otherwise deductible under Section 216(a)(2), IRC, should not be, and are not, within the intended limitation applicable to investment interest under proposed Section 221. This should be made clear by an expression to that effect by this Committee.

BEFORE THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

Statement of William H. Doughty, President of the National Association of Real Estate Investment Funds

SUMMARY OF PRINCIPAL POINTS

1. Under section 452, a corporation which uses the rapid depreciation methods (allowable under section 167(b)(2) of the Internal Revenue Code) must, for the purpose of computing its earnings and profits, deduct only straight-line depreciation. The result is that the stockholders may be taxed on distributions in excess of those which would be taxed under present law.

2. The Internal Revenue Code defines the term "corporation" as including a real estate investment trust, though such a trust is not taxed on its real estate investment trust income if its distributes 90% or more of such income to its shareholders.

3. On the other hand, an individual owner of real property is allowed to use the accelerated depreciation deductions to reduce his taxable income from the property.

4. The application of the rule of section 452 to real estate investment trusts would frustrate the legislative intent expressed when the special provisions for taxing their shareholders were enacted in 1960. The expressed purpose at that time was to secure for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate directly, by permitting pooling arrangements by small investors, in order that they might secure the benefits normally available only to those of larger resources.

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5. To preserve and continue the purposes thus expressed for the enactment of the real estate investment trust provisions, the above mentioned rule as to the determination of a corporation's earnings and profits available for dividend purposes should not apply to the shareholders of such trusts.

BEFORE THE COMMITTEE ON FINANCE

OF THE

UNITED STATES SENATE

Statement of William H. Doughty, President of the National Association of Real Estate Investment Funds

I am William H. Doughty, president of the National Association of Real Estate Investment Funds, president of Chinnock & Doughty, Chicago, and trustee of Bradley Real Estate Trust and of Chicago Real Estate Trustees. NAREIF was founded in September, 1960, with the following aims and purposes:

> To broaden public understanding of the importance and value of real estate investment trusts to the American economy and the investing public,
>
> To promote the purposes and effectiveness of these trusts by any means consistent with the public interest,
>
> To provide a national medium for the exchange of ideas and information regarding the establishment and efficient and proper operation of such trusts,
>
> To cooperate with and appear before governmental departments, agencies, and committees on matters affecting the industry,
>
> To provide a national association of representatives of real estate investment trusts and of individuals who have a business or professional interest in such trusts,
>
> To establish suitable liaison and cooperate with local, regional and national groups of other associations.

Members abide by a rigid code of ethics adopted by the Association.

Thirty-eight leading trusts, of both the equity and mortgage types, are members of the Association. These trusts account for the major portion of the total assets of the industry and have in excess of 65,890 shareholders who have pooled their funds for real estate investment. An additional group of 75 firms directly associated with the industry are also members of NAREIF.

My purpose in asking to appear before you is to call attention to what we believe was an inadvertent error or oversight in the drafting of section 452 of the House bill.

Under that section, a corporation which uses the rapid methods of depreciation (allowable under section 167(b)(2) of the Internal Revenue Code) must, for the purpose of computing its earnings and profits, deduct only straight-line depreciation. That is to say that, where a corporation computes its taxable income by using accelerated depreciation, its shareholders may be taxed on distributions in excess of those which would be taxed under present law.

On the other hand, an individual who owns such property would be allowed the accelerated method of depreciation to reduce his taxable income from the property.

It is the use of the term "corporation" in this section of the bill that causes us justifiable concern. That term is defined in the Internal Revenue Code in a way which includes real estate investment trusts, which we respectfully assert should not have the same rule applied to them, since this would involve a complete reversal of the policy announced by the Ways and

Means Committee in reporting out H. R. 12559, which passed the House on June 29, 1960, and was added by the Senate as an amendment to H. R. 10960. H. R. 10960 was enacted as Public Law 86-779, 74 Stat. 998, approved September 14, 1960, which added sections 856-858 to the Internal Revenue Code.

The report of the Ways and Means Committee on the substantive provisions of H. R. 12559 which have now become law was House Report No. 2020, 86th Congress, 2d session. The reasons for the enactment, set forth in that report, were as follows:

> "The omission of the corporate income tax in the case of distributed earnings, which present law provides for regulated investment companies, secures for investors in these companies essentially the same tax treatment as they would have received if they had invested directly in the operating companies. H.R. 12559 extends this same type of tax treatment to real estate investment trusts specializing in investments in real estate equities and mortgages as distinct from the stock and security holdings of regulated investment companies. Thus this secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly and, therefore, equates their treatment with that accorded investors in regulated investment companies." (Emphasis supplied.)

The Committee report further stated that this tax treatment is desirable, since this investment method constitutes "pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources" which advantages include "the spreading of the risk of loss by the greater diversification of investment * * *; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investor could not undertake singly." The intent that real estate investment trusts should be a vehicle for public and not concentrated investment in real estate is further evidenced by the requirement, in section 856 of the Code, that there be at least 100 owners of shares in order for the conduit tax treatment to apply.

That report further stated that "the real estate investment trust taxable income [i.e., income determined after allowable deductions, including depreciation] will be taxable to the beneficiaries as ordinary income."

Section 452 of the pending bill clearly would frustrate the stated purpose of the real estate investment trust provisions to "secure for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities * * * directly."

It should be pointed out, that as a part of the price for securing this conduit tax treatment for the shareholders of real estate investment trusts, which would otherwise be taxable as corporate income, the trusts are denied the following benefits of ordinary business corporations:

1. The trust may not hold any property primarily for sale to customers in the ordinary course of its trade or business.

2. At least 75% of the value of the trust's assets must be represented by real estate assets, cash and cash items, and Government securities.

3. Not more than 25% of the value of the trust's total assets may be represented by other securities; not more than 5% of such value may be represented by securities of a single issuer; and the Trust may not own more than 10% of the outstanding voting securities of such an issuer.

4. The deduction for dividends received, allowable to other corporations under section 243, is not allowed in computing the real estate investment trust income.

5. The net operating loss carryovers and carrybacks, allowed to corporations by section 172, are not allowed to real estate investment trusts.

These restrictions were imposed, in the words of the Ways and Means Committee's report, in order to "draw a sharp line between passive investments and the active operation of business."

To preserve and continue the purposes thus expressed for the enactment of sections 856-858 of the Code, it is requested that section 452 of H. R. 13270 be amended by adding thereto a paragraph reading as follows, or its equivalent in purpose and effect:

"(3) The provisions of paragraphs (1) and (2) shall not apply to real estate investment trusts, as defined in section 856."

PART B—ADDITIONAL STATEMENTS

CAPITAL CONCEPTS CORPORATION
SUITE 820, KIRKEBY CENTER / 10889 WILSHIRE BOULEVARD / LOS ANGELES, CALIFORNIA 90024 / (213) 473-0801 · (213) 879-0333

September 15, 1969

Senate Finance Committee
2227 New Senate Office Building
Washington, D. C.

Gentlemen:

It is my considered opinion that it would be a mistake to eliminate accelerated depreciation as proposed in the Tax Reform Bill as reported out of the House Of Representatives.

As you are well aware, the present real estate market is in a state of extreme depression. It is very difficult to purchase investment quality real estate and even more difficult to sell investment real estate at a price sufficient to yield a reasonable return on the initial investment. The price of real estate is a function of the economic return that it generates. A substantial portion of the return generated by real estate through the present time has been the tax benefits created by the interest and depreciation deduction allowed to the owner of the real estate.

Our firm specializes in purchasing, for our clients, investment quality real estate. By the end of 1969 our real estate holdings will exceed fifty million dollars. In many cases we will purchase apartment houses where the cash return is quite low but where the tax benefits to the investor are substantial and the potential for appreciation, we feel, is great.

If there were no substantial tax benefits to be gained by owning real estate we would have three courses of action open to us.

1. Pay considerably less money for the real estate, which would result in a higher cash yield to the investor.

2. Pay the same price for the real estate but raise the rents substantially after the purchase.

3. Find another suitable investment vehicle other than real estate.

It is my opinion that the effect of the reduced tax savings will be a substantial across the board increase in rents to raise the return to real estate investors so that the need for residential units can be met. The argument is made that accelerated depreciation is continued to be allowed to original owners of apartment houses. That in itself is not satisfactory because firms such as ours only buy existing structures. The initial builders must be able to anticipate a profit on sale or they will not build the building even through the builder may receive the tax benefits.

There are two reasons for this.

1. As you know the tax benefits to the original builder, under

the new law, will be illusory because of the recapture provisions.

2. There will be no market to re-sell the property because the second buyers will not receive any tax benefits.

It is my opinion that the economy is a self adjusting device that adjusts for tax benefits. In other words, an investor expects a 15% yield on his invested dollars. He is willing to take part of his yield in tax benefits if they are available. If they are not available then he must have a greater cash yield to off-set the lost tax benefits. The net result of this is that if you remove the tax benefits from real estate the yield on real estate will have to rise which will cause increased rents and greater inflation.

Very truly yours,

CAPITAL CONCEPTS CORPORATION

Lawrence M. Schulner
President

LMS:mtb

S T A T E M E N T

to

THE SENATE FINANCE COMMITTEE

ON THE SUBJECT OF H.R. 13270

THE TAX REFORM ACT OF 1969

Purpose of statement.

The purpose of this statement is to bring to the attention of the Senate Finance Committee what appears to be an omission in section 521 of H.R. 13270 as passed by the House of Representatives, and to propose an amendment that would cure that omission.

Section 521 would add a new subsection (j) to section 167 of the Code, limiting depreciation deductions in the case of real property. Paragraph (4) of section 167(j) would limit the allowance for depreciation "in the case of section 1250 property acquired after July 24, 1969." [Emphasis added].

The word "acquired" might easily be read to include acquisitions, after July 24, 1969, by way of tax-free transfers under sections 332, 351, 368 and 721 of the Code, although this does not appear to have been intended.

Proposed amendment.

In order to make it clear that such acquisitions are not to be considered under section 167(j)(4), a sentence should be added at the end of paragraph (4), substantially identical to the last sentence of section 167(j)(3), as follows:

> "Under regulations prescribed by the Secretary or his delegate, rules similar to the rules provided in paragraphs (5), (9), (10), and (13) of section 48(h) shall be applied for purposes of this paragraph."

Since the same sentence would thus be duplicated in paragraphs (3) and (4), the Committee might consider it better form to delete the sentence from paragraph (3) and to create a new paragraph (5) as follows:

> "Under regulations prescribed by the Secretary or his delegate, rules similar to the rules provided in paragraphs (5), (9), (10), and (13) of section 48(h) shall be applied for purposes of paragraphs (3) and (4)."

Discussion.

As indicated above, it does not appear that the House intended that section 167(j)(4) should apply to acquisitions in which the transferor's basis is carried over to the transferee.

Section 521(f) of H.R. 13270, amending section 381(c)(6) of the Code, provides an exception from section 167(j) for acquisitions after July 24, 1969 in transactions covered by section 381(a) -- namely, liquidations under section 332 and certain reorganizations under section 368. This is accomplished by treating the transferee in those transactions as the transferor would have been treated had he retained the property. Section 381(c)(6), however, would not apply to transactions involving partnerships and other noncorporate transferees.

A similar problem arises in paragraph (3) of proposed new section 167(j), dealing with depreciation on newly constructed property, but there the House specifically provided an exception for all of the foregoing acquisitions. It directed (in the last sentence of paragraph (3)) that "rules similar to the rules provided in paragraphs (5), (9), (10), and (13) of section 48(h) shall be applied. . . ." Section 48(h) of the Code, dealing with suspension of the investment credit, provides (in subsection (h)(9)) for treating certain transferees as the transferors would have been treated. The provision covers transactions "as a result of which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731."

These provisions in new section 167(j)(3) and amended section 381(c)(6) evince an intention on the part of the House to provide a carryover of status for property acquired after July 24, 1969 in certain types of transactions. No cogent reason exists for not affording that carryover of status to noncorporate acquisitions under new section 167(j)(4).

If the legislative intention was not clearly defined during passage of the Bill by the House, then it is submitted that such carryover of status should be provided and that precedent exists in several areas under the Code.

The purpose of section 167(j)(4) as stated in the Report of the Committee on Ways and Means (H. Rept. No. 91-413 (Part 1) page 167) is to "eliminate the repeated sale and resale of property for the purpose of tax minimization." This tax minimization may be accomplished under present law by the purchase of property in a transaction in which the transferee obtains a step-up in basis, which then becomes subject to depreciation deductions in the hands of the transferee. However, an acquisition which results in a carryover of basis to the transferee does not lend itself to this abuse. Such acquisitions could be provided for by applying the rules of section 48(h)(9), perhaps being further limited to section 48(h)(9)(A)(ii). The rules of section 48(h)(10) and (13) involve situations which similarly do not appear to fall within the abuse sought to be curtailed. (The rules of section 48(h)(5) do not actually apply, but have been included above to be consistent with the language of proposed new section 167(j)(3) in H.R. 13270). Therefore, the proposed amendment would be consistent with the House's stated purpose of preventing unwarranted tax minimization.

In addition to section 48(h)(9) referred to above, which deals with the investment credit, a similar rule was adopted in section 167(i)(1) of the Code when that section was amended in 1967 to reinstate certain depreciation methods that had been temporarily suspended along with the investment credit. Section 167(i) is entitled "Limitation in Case of Property Constructed or Acquired During the Suspension Period."

Similarly, when section 1245 was enacted in 1962 and again when section 1250 was enacted in 1964, exceptions were provided "if the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731 . . . ." I.R.C. §§1245(b)(3), 1250(d)(3).

Summary.

The suggested amendment is intended to provide for a carryover of status from the transferor to the transferee in certain acquisitions under proposed new section 167(j)(4). The omission of such a provision appears to have been unintentional in light of proposed new section 167(j)(3) and amended 381(c)(6), both of which would provide for such a carryover of status in similar acquisitions. The proposed amendment would be consistent with existing precedents and with the stated purpose of the House Committee on Ways and Means to prevent unwarranted tax minimization.

Sidney I. Roberts
Roberts & Holland

September 16, 1969
New York, New York

STATEMENT FOR THE SENATE FINANCE COMMITTEE
WITH REGARD TO SECTIONS 451 AND 452 OF THE TAX REFORM BILL
BY MR. ERNEST L. GROVE, JR., VICE PRESIDENT AND
CHIEF FINANCIAL AND ACCOUNTING OFFICER OF NORTHEAST UTILITIES

(Northeast Utilities is a utility holding company system operating in Connecticut and western Massachusetts. Its principal operating subsidiaries are The Connecticut Light and Power Company, The Hartford Electric Light Company, Western Massachusetts Electric Company, and The Holyoke Water Power Company.)

Northeast Utilities believes that Section 451 of the Tax Reform Bill is inappropriate tax legislation. First, we feel it is wrong to make regulatory accounting procedures determinative of income tax deductions. This Bill would deny the benefits of accelerated depreciation to those public utilities regulated by commissions which adopt the "flow through" method of accounting. Under this Bill, a utility company's deduction for depreciation, which is the largest single deduction most utilities have, would be controlled by accounting policies adopted by the regulatory commission. We believe that to permit policies and procedures of regulatory commissions to determine tax effects is a questionable precedent for the Congress to adopt.

Second, the requirements in Section 451(a)(2) and (3) of the House Bill for the actual use of flow through in establishing cost of service on and prior to July 22, 1969, in order to utilize flow through are too rigid and inflexible. They fail to recognize those situations where a regulated utility which was using accelerated depreciation had taken positive and concrete steps to change from normalization to flow through prior to such date but where such change had not yet been authorized or implemented.

As an example of the difficulties and anomalies that this section of the Bill in its present form will create, may I cite the situation in Massachusetts with respect to our subsidiary, the Western Massachusetts Electric Company. This Company has been utilizing an accelerated depreciation method on its tax returns. However, for rate-making purposes, it has been obliged by the Massachusetts Regulatory Commission to "normalize," that is, to charge the tax reduction as a current tax expense and reflect it in its rates to its customers. Since May 1969, the Massachusetts Department of Public Utilities has had under formal consideration and advisement a change in the accounting method required of regulated public utilities from "normalization" to the "flow through" method. At a hearing before the Department in May of this year, Western Massachusetts Electric Company pledged to reduce its rates to its customers by an annual amount of at least $1,700,000 if the Department would permit the use of the flow-through method. Before the Department had had opportunity to act, the House passed the present Bill. Now Section 451 will prevent this rate reduction which the Company is desirous of making since a "flow through" accounting order in Massachusetts would automatically result in the denial under this Bill of the use of accelerated depreciation to the Western Massachusetts Electric Company.

We respectfully suggest that Section 451 be modified to provide for situations where the regulated public utility has, on or before July 22, 1969, taken steps to obtain authorization to adopt flow-through accounting. This would be only equitable since the proposed tax legislation was not the inducement for proposing the accounting change.

With respect to Section 452 of the Tax Reform Bill, we would urge that if the Congress feels corrective action is required in this area, then the situation should be approached with a phase-out method, as President Nixon originally proposed, rather than with an absolute cut-off for tax years beginning after June 30, 1972, as Section 452 is presently written. The effect of the absolute cut-off date would mean that Northeast Utilities, for example, might have a return of capital dividend of, say, 60 percent in 1972 which would abruptly become fully taxable in 1973. We believe this would have a serious detrimental effect on the market price of our common shares. Also, it should be pointed out, a phase-out method would increase Treasury revenues in the interim years.

STATEMENT OF DR. HOMER A. BLACK
ON BEHALF OF
UNITED STATES INDEPENDENT TELEPHONE ASSOCIATION
IN SUPPORT OF SECTION 451, TITLE F, H. R. 13270
TREATMENT OF ACCELERATED TAX DEPRECIATION
IN REGULATED INDUSTRY
BEFORE COMMITTEE ON FINANCE
OF
U. S. SENATE

SEPTEMBER 26, 1969

SUMMARY OF STATEMENT OF DR. HOMER A. BLACK
TO THE SENATE FINANCE COMMITTEE
IN SUPPORT OF SECTION 451 OF TITLE F OF H. R. 13270
RELATIVE TO TREATMENT OF ACCELERATED TAX DEPRECIATION
IN REGULATED INDUSTRY

Purpose of Statement

The purpose of Section 451 of H. R. 13270 is to assure that the original Congressional intent of the accelerated depreciation provision in Section 167 of the Internal Revenue Code is carried out. According to Committee reports, the faster tax write-off is intended to aid growing businesses in financing expansion and modernization by increasing available working capital.

Enactment of this proposed legislation, Section 451, is vitally important to the 2,000 Independent telephone companies because accelerated tax depreciation can provide them about 10 percent of the funds they need annually -- $140 million of the $1.4 billion total -- to finance investment in new plant and equipment.

The Congressional intent of Section 167 of the Internal Revenue Code has been realized for non-regulated businesses, which have obtained substantial amounts of new capital by using accelerated depreciation for tax purposes. Regulated utilities are increasingly being denied by flow-through accounting or imputed flow through the use of funds which they obtain from accelerated tax depreciation.

One result of this trend to flow-through is to deny regulated companies money needed in financing the new plant and equipment necessary to meet the accelerating demand for telephone services. Other results are the inequitable distribution of the benefits of accelerated tax depreciation between current and future customers, and the potential loss to the Federal Treasury of $1.5 billion annually in tax revenues.

Consideration by House Ways and Means Committee

The House Ways and Means Committee studied comprehensively the consequences of present practices under the accelerated tax depreciation provisions of the Internal Revenue Code. As a result, the Committee drafted Section 451 of the Bill now being considered so as to assure that the tax depreciation provisions will more effectively accomplish their intended working capital purposes.

<u>Advantages of Section 451</u>

Enactment of Section 451 is desirable because:

(1) It eliminates the $1.5 billion potential loss of Federal revenues expected if the current trend to flow through is continued.

(2) It requires no change in tax depreciation practices that will disrupt the existing rate structures of regulated utilities.

(3) It does not impair the authority of regulatory agencies to regulate the rates or accounting practices of utilities.

(4) It enables utility companies, with the consent of their regulatory authorities, to use funds from accelerated tax depreciation to finance new plant and equipment, just as non-regulated companies are now doing.

(5) It assures a more equitable distribution of the benefits of accelerated tax depreciation between present and future utility customers.

(6) It limits the extent to which regulated companies become dependent on continuation of accelerated tax depreciation measures, and protects the usefulness of these measures in promoting necessary economic development.

Mr. Chairman, members of the Committee:

This statement is submitted at the request of the United States Independent Telephone Association to express support and emphasize the importance of Section 451 of H. R. 13270 to the Independent (non-Bell) segment of the telephone industry.

I am Professor and Chairman of Accounting at Florida State University. I hold a Ph.D. degree in Business Administration from the University of Michigan and am a Certified Public Accountant. I am the author of Accounting Research Study No. 9, "Interperiod Allocation of Corporate Income Taxes," published in 1966 by the American Institute of Certified Public Accountants. This study was the basis on which the Accounting Principles Board issued its opinion requiring normalization.

On March 26, 1969, I testified before the House Ways and Means Committee in support of proposed legislation designed to insure that the Congressional intent in providing for accelerated tax depreciation was carried out.

There are approximately 2,000 Independent telephone companies which serve more than one-half the geographical area of the nation, primarily in the smaller communities - the suburban and rural areas. The Independent telephone companies had 18 million telephones in service in 1968, representing a plant investment of almost $10 billion. For the past 10 years customer demand for the services of the Independents has grown at an average rate of 10.7 percent a year. This is almost double the rate of increase of the Gross National Product.

Last year the Independents were investing new capital at an annual rate of $1.4 billion to improve their services and to expand their plants and facilities. By 1970 the industry will have 20.8 million telephones in service, representing a total plant investment of $12.5 billion and consumer demand of $2.8 billion per year.

Depreciation is the largest single expense item of the Independent telephone industry. It amounts to approximately $425 million per year, which is 24 percent of the industry's total operating expenses and taxes. It is estimated that about 10 percent of the funds annually needed by the Independent telephone companies for plant investment might be derived from industry-wide use of accelerated tax depreciation. Because of the amounts involved, the enactment of the provisions of Section 451 of H. R. 13270 is most important.

The Problem

The following circumstances underlie the urgent need for Section 451 in the legislation adopted by the House:

Section 167 was enacted to provide working capital

When Congress passed Section 167 of the Internal Revenue Code in 1954, the Committee reports stated that "the faster tax write-off would increase available working capital and materially aid growing businesses in the financing of their expansion." (H. Report 1337 and S. Report 1622). The House report recognized that "the changes made by your committee's bill affect the timing and not the ultimate amount of depreciation deductions with respect to a property."

The intent of Congress has been achieved for non-regulated businesses

Non-regulated businesses have increased their cash flow and thereby obtained the use of capital through adoption of accelerated tax depreciation in either of two ways:

(1) They have used accelerated depreciation for both book and tax purposes, or

(2) They have used accelerated depreciation for tax purposes, and straight-line depreciation for book purposes, and have normalized.

Normalization is an accounting procedure required by the accounting profession and the Securities and Exchange Commission for non-regulated industry. Under this procedure the amount of the taxes deferred by using accelerated tax depreciation is placed in a reserve for future payment. Thus, it is clearly recognized that accelerated tax depreciation results in a deferral of tax payment, not in a cost saving.

Regulated businesses have been subjected to different treatment

Under rules established by regulatory agencies, utilities are generally required to use straight-line depreciation for book purposes. Although utilities using accelerated depreciation for tax purposes were initially permitted to normalize the deferred taxes, many are now being required to "flow through". Under "flow through" the funds provided by lower current tax payments resulting from the use of accelerated tax depreciation are erroneously treated as additions to net earnings after taxes, rather than correctly as a temporary source of working capital.

Recent developments stress the need for remedial legislation

(a) Action of regulatory bodies

In recent years, both Federal and state regulatory agencies have increasingly been adopting flow-through treatment. Some agencies that initially authorized normalization have reversed their policy and are requiring flow through. Thus, contrary to the intent of Congress, utilities are increasingly being denied the right to use working capital obtained through the use of accelerated tax depreciation benefitting consumers over a period of years.

Federal tax revenues that were intended by Congress for business investment are being diverted instead to subsidize only present utility consumers. Furthermore, in recent months some agencies have required utility companies to compute their earnings as if they had used accelerated tax depreciation, and to flow through to consumers the imputed tax benefits even though the companies had actually been using straight-line depreciation for tax purposes.

The increasing requirement of flow-through, and imputed flow-through, is of particular concern to the Independent telephone companies because it places them at a competitive disadvantage. They must compete with non-regulated industry to raise large amounts of capital, under current high interest rates, in order to provide the larger quantity and higher quality of services demanded by their customers.

(b) Loss of Federal tax revenues

The Treasury Department advised the Ways and Means Committee that "If utility commissions generally proceed to treat companies as though they had adopted accelerated depreciation

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and require this amount to be flowed through, the total impact on (Federal) revenues, over the next few years, could build up to an annual loss of $1.5 billion."

Comprehensive Consideration by the
Ways and Means Committee

The Ways and Means Committee devoted most of two days to hearing testimony from and questioning 15 witnesses on the problems created by methods presently required in accounting for accelerated tax depreciation. These witnesses included representatives from four Federal regulatory agencies; a state public service commission; a national public accounting firm; and electric, gas and telephone companies; as well as economists and an investment banker. In addition, statements were filed by 14 others representing utilities, consumers and regulators.

The testimony developed in detail the points of view of regulatory agencies, regulated utilities and others who are vitally concerned about the uneconomic and inequitable results of present practices under the existing provisions of Section 167 of the Internal Revenue Code.

Summary of Section 451, Subtitle F of H. R. 13270

In drafting Section 451, the Ways and Means Committee reaffirmed that the use of accelerated tax depreciation results in a "deferral" of Federal income tax payments and not a "saving" of taxes. As drafted, the Section assures that accelerated tax depreciation provisions of the Internal Revenue Code will more effectively accomplish their intended purpose and prevent the unintended drain on Federal revenues.

The Section applies to property used in the furnishing of electrical energy; water; sewage disposal services; gas through a local distributing system; telephone services (excluding ComSAT); and transportation of gas, oil, or petroleum products by pipelines, if rates for these services are regulated by a utilities commission.

As to all such property constructed or acquired up to January 1, 1970, the following rules apply:

(1) If straight-line depreciation is presently used for tax purposes, then no other method is permitted;

(2) If accelerated depreciation is used for tax purposes, with "normalization", the utility must continue to do so unless it changes to straight-line; and

(3) If accelerated tax depreciation is used with flow-through no change is made.

As to new property (after December 31, 1969), the provisions are:

(1) If the taxpayer presently uses accelerated tax depreciation and flow-through, no change is made.

(2) In all other cases accelerated tax depreciation may be used only if the utility taxpayer normalizes the deferred income taxes.

The Section will permit any necessary changes in the methods used by taxpaying utilities, and authorized by regulatory commissions, in implementing the public policy to be made in an orderly way, without hardship to the utility consumer, the utility enterprise, or the Federal Treasury.

Reasons For Adopting Section 451

(1) Section 451 will eliminate the potential $1.5 billion annual loss of Treasury tax revenue that is expected to result from continuation of the current regulatory trend to require utilities to use accelerated tax depreciation with flow through. Section 451 will prevent adverse tax revenue effects with respect to existing property by prohibiting:

a. A company which now uses straight-line tax depreciation from switching to accelerated tax depreciation.

b. A company which now uses accelerated tax depreciation, and normalizes, from switching to flow through.

Adverse tax revenue effects will also be prevented by allowing only those taxpayers who are now using flow through to do so on property added after 1969. Even those companies may normalize if they receive regulatory approval.

(2) Section 451 requires no change in the existing use of tax depreciation methods by utilities that will disrupt the rate structures prescribed by regulatory agencies.

<u>Section 451 does not infringe upon the present authority of regulatory agencies</u> to regulate the rates or accounting practices of utilities under their jurisdiction. The authority of regulatory agencies to exclude a normalization reserve from the rate base in the same manner that depreciation reserves are excluded remains unaffected. By such exclusion the consumer receives the benefits of the use of the money. Thus, Section 451 amends the tax law merely to insure that the original intent of Congress is achieved.

(3) Section 451 enables the original purpose of Congress - to provide working capital for all industries - to be accomplished for regulated firms as it is now being accomplished by non-regulated firms. When the regulatory agency permits normalization accounting, a regulated company may use accelerated depreciation for tax purposes and thereby obtain the use of working capital as intended by Section 167 of the Internal Revenue Code.

(4) Section 451 assures a more equitable distribution of the benefits of accelerated tax depreciation between present and future customers of those utilities which normalize.

All customers benefit when a company normalizes because the company's cost of capital is reduced.

(5) Section 451 protects the usefulness of an important measure of Federal tax and fiscal policy - accelerated tax depreciation - in promoting necessary economic development. By limiting the use of flow-through for the future, this Section reduces the extent to

which utility companies become dependent on continuation of these measures. If utility companies generally adopt the use of flow through, Congress would find it difficult to reduce or repeal tax provisions for accelerated depreciation regardless of the national policy requirement for such a change.

Conclusion

I wholeheartedly endorse the enactment of Section 451 as a means of accomplishing the original intent of Congress, reflected by Section 167 of the Internal Revenue Code, in an effective, equitable, and orderly manner. This Section substantially avoids the increasing drain on Federal revenues from existing practices, avoids infringing on the prerogatives of the regulatory agencies, and benefits utility customers and utility companies.

Committee on Finance

United States Senate

Written Statement of the

Association of Oil Pipe Lines

on

Section 451 of H.R. 13270

The Proposed Tax Reform Act of 1969

Submitted by

J. D. Durand
General Counsel
Association of Oil Pipe Lines

September 26, 1969

Summary

Section 451 of H.R. 13270 would have the effect of classifying oil pipelines, alone of all forms of transportation regulated by the Interstate Commerce Commission, as public utilities with guaranteed rates of return and "freezing" them in the methods of depreciation they are now using. With respect to the new pipeline companies which each year enter the ranks of the industry, section 451 would compel them to use straight line depreciation only. The Association of Oil Pipe Lines (AOPL), which is composed of substantially all of the oil pipelines regulated by the Interstate Commerce Commission, believes that such a classification is incorrect and improper for three principal reasons. First, the oil pipelines are not monopolistic utilities with guaranteed rates of return. They are in law and in fact true common carriers subject to strong competition from the water carriers (barge lines), the motor carriers and the railroads, the remaining forms of transportation regulated by the ICC. Second, all of the forms of transportation which compete with the oil pipelines have been excluded from section 451, and to leave oil pipelines subject to that section, contrary to the recommendations of the ICC, would result in a serious tax discrimination against them and in favor of their competitors. Third, the oil pipelines do not create for the Treasury Department a revenue loss problem from "flow through."

For these reasons, which have been set forth in detail in the following statement, AOPL urges the Committee on Finance to amend section 451 to exclude oil pipelines therefrom. This can be done by deleting from section 451, at lines 8 and 9, on page 268 of the bill, the words ", oil (including shale oil), or petroleum products."

1. Oil pipelines are in law and in fact true common carriers and there is "freedom of entry" into the oil pipeline transportation field.

The oil pipeline companies are in law and in fact true common carriers. Insofar as the legal situation is concerned, they are, like the railroads, subject to Part I of the Interstate Commerce Act and thus come under the economic regulatory jurisdiction of the ICC although no certificate of public convenience and necessity or operating permit from the Commission is needed to enter the common carrier oil pipeline business. Pipelines are required to file tariffs covering their transportation of petroleum and petroleum products and strictly abide by those tariffs in all instances; their rates and charges to shippers must be just and reasonable; the transportation of petroleum and petroleum products must be performed under just and reasonable regulations and practices and no pipeline may grant unreasonable preference to any shipper or unduly discriminate among shippers in any way in connection with its services; transportation must be furnished to all shippers upon reasonable request therefor and reasonable through rates and services with other pipelines must be established; pipelines may not pool traffic, services or earnings except with the approval of the Commission, and all pipelines must keep their accounts and records in conformity with the Uniform System of Accounts for Pipelines prescribed by the ICC.

Oil pipelines serve simply as common carriers for all petroleum shippers who offer crude oil or petroleum products to them for transportation in accordance with the tariffs which the pipelines have on file with the ICC. The oil pipelines do not buy or sell petroleum or petroleum products and they do not own the petroleum or petroleum products which they transport. In this important respect they differ completely from the gas transmission lines. They also differ importantly from the electric, water and telephone companies since they do not sell products or services to the general public but only provide a mode of transportation to producers and refiners of petroleum.

Since, as stated above, a certificate of public convenience and necessity or operating permit is not required to enter the common carrier oil pipeline business, there is freedom of entry into this mode of transportation. Studies made by AOPL indicate that fourteen new oil pipeline companies have begun operations during the five and one-half year period since January 1, 1964. Clearly, therefore, transportation of oil by pipeline is not a monopolistic industry.

2. The common carrier oil pipelines are in direct competition with the inland water carriers (barge lines), the motor carriers and the railroads and should be treated in the same way as these competitors are treated with regard to permitted methods of tax depreciation.

This Association annually compiles data showing the relative tonnage of petroleum and petroleum products carried in domestic transportation by the pipelines, the water carriers (barge lines), the motor carriers and the railroads. For 1967, the latest year for which data are available, and which is a typical year, the oil pipelines carried 45.64% of the total tons of crude petroleum and petroleum products carried in domestic transportation by the four modes specified. The motor carriers were second with 29.13%, the water carriers third with 23.50% and the railroads fourth with 1.73%. It can be truly said that competition from motor carriers and water carriers is significant since together these two modes carry more tonnage than the oil pipelines. While the pipelines are the principal mode of transportation of crude petroleum, the water carriers carry 18.79% of this commodity and the motor carriers carry 7.37%. With regard to petroleum products carried in domestic transportation, the oil pipelines carry 29.25% of the total tonnage, far short of the 41.87% carried by the motor carriers and only slightly more than the 26.26% transported by the water carriers.

These figures point up the correctness of the reference to "the existence of strong competitive forces" among the ICC regulated carriers referred to at the bottom of page 2 of the letter of April 15, 1969, to the Ways and Means Committee from the Chairman of the ICC (copy attached). It would be obviously unfair to permit, as section 451 contemplates, the water carriers, the motor carriers and the railroads to continue to have the right to select the method of depreciation most advantageous to them and to prevent the oil pipelines from exercising this choice.

3. <u>Subjecting oil pipelines to the provisions of proposed section 451 would be contrary to the recommendations of the ICC.</u>

The April 15, 1969, letter to the Ways and Means Committee from the Chairman of the Interstate Commerce Commission, to which reference was made above, urges that <u>all</u> modes of transportation regulated by the ICC be treated alike insofar as methods of tax depreciation are concerned. The letter refers to the strong competition which exists among the modes of transportation regulated by the ICC and the fact that (bottom of page 3 and page 4) "The interplay of competitive forces keeps the rate structure in a constant state of change" and that "in many cases where the Commission has permitted increases in the rates of a particular mode to take effect, competition from other regulated modes or unregulated transportation has subsequently forced reduction in these rates to prevent undue diversion of traffic to a competing mode or carrier."

The obvious conclusion from this letter is that all modes of transportation regulated by the ICC -- the railroads, the motor carriers, the water carriers and the oil pipelines -- should be treated alike with regard to such an important tax consideration as methods of depreciation.

This even-handed treatment for all modes of transportation regulated by the ICC is in accord with the National Transportation Policy set forth in the Interstate Commerce Act, which, in part, provides:

> "It is hereby declared to be the national transportation policy of the Congress to provide for fair and impartial regulation of all modes of transportation subject to the provisions of this Act, so administered as to recognize and preserve the inherent advantages of each; * * *"

In connection with the review by the Committee on Finance of the scope of section 451, AOPL strongly recommends that the Committee consult with the ICC and determine its views with regard to the desirability of including oil pipelines under that section.

4. <u>Unlike the rate procedures of the Federal Power Commission and the Federal Communications Commission, the ICC rate procedures do not and cannot result in prescribing levels of earnings for the carriers which it regulates and thus the oil pipelines do not have a guaranteed rate of return</u>.

To classify the oil pipeline transportation industry in the same category for treatment of accelerated depreciation as the gas, telephone, water and electric utility industries appears to involve a moral (and perhaps a legal) wrong, plus an economic monstrosity.

The Interstate Commerce Commission's processes in handling oil pipeline tariff rates are not in any way similar to the processes whereby the FPC, the FCC and state regulatory agencies establish and set rates for gas, electric, water and telephone utilities. Under normal rate procedures, these latter agencies make a determination of the rate level necessary to fix corporate net income at a permitted rate of return on an agreed rate base.

The ICC does not and cannot prescribe earnings for oil pipelines, barge lines, railroads and motor carriers as do the agencies that regulate true utilities since the ICC regulated carriers do not have monopolistic characteristics. The interplay of competitive forces assures that the rate structure will be in a constant state of change.

Distinguishing between oil pipelines and their transportation competitors by putting oil pipelines in a true utility category, in which they do not belong, was probably due to a misunderstanding by the Ways and Means Committee of the nature of oil pipeline transportation, and the Committee on Finance is urged to review carefully the attached letter from the ICC, particularly the following portion (commencing on page 4):

> "In this regard, we should point out that in many cases where the Commission has permitted increases in the rates of a particular mode to take effect, competition from other regulated modes or unregulated transportation has subsequently forced reductions in these rates to prevent undue diversion of traffic to a competing mode or carrier."

This observation is particularly pertinent to oil pipelines since one of our principal competitors, the water carriers, enjoy freedom from rate regulation by the ICC in their transportation of petroleum and petroleum products.

5. <u>The oil pipelines do not create for the Treasury Department a revenue loss problem from flow through</u>.

Since oil pipeline rates are regulated more by competition than by regulatory agency determination, the rate level is not affected by flow through. There have been few rate cases before the ICC affecting oil pipelines. Most of these cases involved only point to point rates and none involved flow through.

The problems that Treasury faces in loss of revenue through flow through of accelerated depreciation centers around the growing practice of regulatory agencies of forcing flow through to <u>residential</u> customers using gas, electricity, water and telephone services. It should be recognized that the customers of the oil pipelines are the corporate producers and refiners who buy and ship crude oil to refinery centers and in turn ship refined products to jobbers. If any flow through should occur from oil pipeline accelerated depreciation, it would go directly to other corporate taxpayers and, by reducing their operating costs, it would increase their Federal income taxes.

6. Conclusion.

In view of the foregoing, AOPL urges the Committee on Finance to amend section 451 to exclude oil pipelines from the classification of public utilities subject to that section. From the viewpoint of even-handed justice and to prevent the tax discrimination which would result against oil pipelines as compared with their competitors, the oil pipelines should be treated similarly to the motor carriers, the water carriers and the railroads with respect to this important tax provision.

J. D. Durand

J. D. Durand
General Counsel
Association of Oil Pipe Lines

Interstate Commerce Commission
Washington, D.C. 20423

April 15, 1969

OFFICE OF THE CHAIRMAN

Honorable Wilbur D. Mills
Chairman
Committee on Ways and Means
House of Representatives
Washington, D. C. 20515

Dear Chairman Mills:

In the course of my testimony before the Committee on March 25, 1969, you and other members of the Committee requested that I provide certain additional information for the record regarding several aspects of the tax expenses incurred by carriers subject to the Commission's jurisdiction and our treatment of such expenses. The information requested is set forth below.

On pages 4210-12 of the hearing transcript, Congressman Burke requested information concerning (1) what taxes, if any, were owed to the Federal Government by the New Haven Railroad and by whom were they assumed; and (2) whether the Commission in its recent approval of Penn Central's request to increase fares reached its decision on the basis of the operation of the New Haven Railroad prior to takeover or if it was based on the anticipated revenue this year in view of the abandonment of 91 trains and other things before the Commission.

As to the first question, the New Haven Railroad had the following current tax liabilities due the United States Government at the time its operations were taken over by the Penn Central: $83,266 representing Federal income taxes of

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leased lines and $1,021,435 payroll taxes. Under the agreement Penn Central acquired certain current assets and assumed certain current liabilities, including $45,661 of the Federal income taxes and the $1,021,435 payroll taxes. The New Haven Railroad is to pay Penn Central in cash the excess of the liabilities over assets. We have been advised that the taxes in question were paid by Penn Central in January 1969. The remaining $37,604 of income taxes is still a liability of the New Haven.

We are unable to provide any information on the second question since the passenger fare increase proposed and put into effect by Penn Central was not applicable to passenger service performed over lines of the New Haven.

On page 4248 of the hearing transcript, you requested the views of the Commission with respect to effect on industries subject to our jurisdiction if Congress were to repeal the present provisions of the tax laws dealing with accelerated depreciation or were to otherwise deprive such industries "of anything other than stright line [depreciation]?"

As indicated in my testimony before the Committee, the regulatory problems with respect to maximum rates and earnings of regulated surface transportation carriers are not as significant for the Commission as they are for other agencies engaged in regulating other public utilities. This is largely due to the existence of strong competitive forces, both within the regulated portion of the industry and without, in the form of unregulated for-hire and private carriage. These strong competitive pressures generally serve to keep rates from exceeding a reasonable maximum level, thus minimizing the necessity for the Commission to prescribe a maximum rate level or otherwise intervene in the ratemaking process to the same extent required in the case of the regulation of industries with monopolistic characteristics. Because of these competitive forces, we do not believe that the denial of accelerated depreciation to regulated industries, as suggested by the Federal Power Commission (Testimony of Chairman White, Tr. p. 4131), would be in the best interests of the carriers subject to our jurisdiction or to the growth and development of an economically sound transportation system. In essence, it is our understanding that the position of the Federal Power Commission is premised on the concept that if additional stimulation is required for the attraction of capital in a regulated industry, it is the responsibility of the appropriate regulatory agency to approve or to prescribe a level of rates sufficient to attract such capital rather than having such capital attracted through incentives in the tax laws. Put differently, the burden of attracting new capital into the regulated industry should fall upon the ratepayer rather than the taxpaying public as a whole. (Testimony of Chairman White, Tr. p. 4123).

While the principle described above can be logically applied to industries having the monopolistic characteristics of those subject to regulation by the Federal Power Commission, this principle could not be applied with any precision in the regulated surface transportation industry where the interplay of competitive forces keeps the rate structure in a constant state of change. In this regard, we should point out that in many cases where the Commission has permitted increases in the rates of a particular mode to take effect, competition from other regulated modes or unregulated transportation has subsequently forced reductions in these rates to prevent undue diversion of traffic to a competing mode or carrier. As long as the transportation ratepayer has this wide choice of options among carriers, the suggestion of the Federal Power Commission could not be meaningfully applied to regulated surface transportation carriers. Given these circumstances, depriving regulated transportation carriers of the use of any method of depreciation, other than the "straight-line method" would result in undesirable effects on the carriers. It would decrease net income of carriers by the amount of additional taxes they would have to pay; assuming operations are profitable. This would reduce the amount of cash available for investment in new property, particularly needed freight cars, maintenance of plant and dividends, among other things. To replenish the cash used to pay additional taxes, it would seem that carriers would have no alternative but to seek relief through requests for increased rates, which, for the reasons mentioned above, might not accomplish the intended effect. Additionally, the immediate resultant decrease in net earnings and cash flow could affect the carriers' credit position and their ability to provide adequate service to the shipping public.

As long as Congress sees fit to provide liberal depreciation methods for tax purposes and the investment tax credit for industry in general, we feel the surface transportation industry should not be deprived of such benefits.

I hope you and the other members of the Committee will find this information helpful.

Sincerely,

/s/ Virginia Mae Brown

VIRGINIA MAE BROWN
Chairman

SUMMARY OF WRITTEN STATEMENT

OF

FLORIDA GAS TRANSMISSION COMPANY*.

September 24, 1969

HR 13270, Section 451, bases the ability of a public utility to use accelerated depreciation in the future upon the filing of its Federal income tax return on or before July 22, 1969. The filing of the tax return is an inappropriate event to determine this question. The significant events to which the future use of accelerated depreciation should be related are either (i) the recording of income tax expense on the regulated books of account or (ii) the filing of rates with the appropriate administrative agency, as of the relevant date selected for such determination.

In the case of Florida Gas Transmission Company, the Internal Revenue Service granted the Company an extension of time to September 15, 1969 for filing its tax return for 1968, the first tax return of the Company which uses accelerated depreciation. Accordingly, this return was not filed until August 25, 1969. However, in August 1968, the Company had filed rates with the Federal Power Commission in reliance upon the use and flowthrough of accelerated depreciation on all property acquired subsequent to 1967. These rates, which have been in effect since February 16, 1969, were based upon a cost of service which included Federal income tax expense at a level approximately $1.6 million a year below what it will be unless the Company is permitted to use accelerated depreciation for tax purposes in 1969 and future years.

Several alternative amendments to HR 13270 are suggested at the end of the Written Statement.

* Submitted by E. P. Shanahan, Vice President and Treasurer

WRITTEN STATEMENT

OF

FLORIDA GAS TRANSMISSION COMPANY

Subject: HR 13270, Section 451

In its bill to reform the income tax laws, the House of Representatives has proposed certain amendments to Section 167 of the Internal Revenue Code which would restrict the right of a public utility to use accelerated depreciation. Section 451 of House Bill 13270 would require the use of straight-line depreciation on public utility property unless a different method had been used on such property for the latest taxable year for which a return was filed on or before July 22, 1969.

In the case of Florida Gas Transmission Company, the proposed requirement of the House Bill that the applicable return be filed on or before July 22, 1969 would have what undoubtedly is an inadvertent result. On June 26, 1969, the Internal Revenue Service granted the Company an extension of time until September 15, 1969 to file its income tax return for calendar year 1968. Thus the Company's 1968 tax return, which will be the first to use accelerated depreciation, was not filed until August 25, 1969. Nevertheless, in August 1968, the Company irrevocably committed itself to the use of accelerated depreciation, with respect to property acquired subsequent to December 31, 1967, by filing rates with the Federal Power Commission in reliance upon the use and flowthrough of accelerated depreciation. These rates have been in effect since February 16, 1969, and will not realize a fair return for the Company without the use and flowthrough of accelerated depreciation on property acquired in 1968 and 1969 (amounting to approximately $90,000,000 of a total plant of approximately $350,000,000). Nevertheless, because for the year 1967 (the latest taxable year for which a tax return was filed on or before July 22, 1969) the Company used solely a straight-line method of depreciation, the Company would be required by the House Bill to remain on straight-line depreciation for all years subsequent to 1968. For the year 1968, however, the Company would be entitled to take accelerated depreciation since the Bill does not apply with respect to taxable years ending before July 23, 1969.

We submit that the crucial determination with respect to its method of depreciation for tax purposes is made by a public utility when it files rates based upon the use and flowthrough of accelerated depreciation and so calculates the income tax expense recorded in its regulated books of account. Once rates have become effective in reliance upon the use and flowthrough of accelerated depreciation for tax purposes, the utility, in effect, has irrevocably committed itself to this method of depreciation so long as those rates remain in effect. Accordingly, the tax reform bill should base the relevant date for determining the future use of accelerated depreciation upon the recordation of income tax expenses in the regulated books of account or the filing of rates with the appropriate administrative agency, instead of or in addition to the date its Federal income tax return was filed.

The following evidences the fact that Florida Gas Transmission Company had decided to take accelerated depreciation during 1968, a year prior to the June 22, 1969 cut-off date presently in the House Bill. On June 17, 1968, the prepared direct testimony of Mr. W. J. Bowen, President and Chief Executive Officer of the Company, was filed with the Federal Power Commission and was formally introduced into evidence on July 18, 1968 at Volume No. 47, page 5923, in rate proceedings RP68-1 and RP66-4. Mr. Bowen stated that:

> "If we are to achieve the rate objectives I have outlined, that is, to produce rates as low as or lower than the 17.9, 21.9 and 57.0 cents per MMBTU rates which we are collecting prior to the in-service date of the CP65-393 facilities exclusive of the surtax and to do so without seriously impairing the Company's financial integrity and competitive position, there is but one course open to us. We must accept the risks inherent in reducing our current revenues by deferring to a later period a part of our tax costs with the concomitant lowering of our financial debt coverages. We must elect to take liberalized depreciation on the CP65-393 facilities and on future plant additions. Therefore, I have asked our people to prepare the testimony and exhibits for the new rate filing on this basis and to request the necessary authorization to reflect "flow through" accounting on those facilities."

On August 1, 1968, the Company made the new rate filing based upon the use of accelerated depreciation with respect to all property acquired subsequent to 1967. The relevant exhibits filed with the Federal Power Commission demonstrating this election are attached hereto as Schedule A. Since August 1, 1968, the Company uniformly has used accelerated depreciation with respect to property acquired subsequent to December 31, 1967 in calculating the income tax expense recorded in its regulated books of account. Since the rates filed on August 1, 1968 were based upon a cost of service which resulted from utilizing accelerated depreciation, thus flowing through the tax reductions to the customers in the form of lower rates, the rates would not provide the Company a fair return if depreciation based upon a straight-line method is required in determining taxable income for 1969 and subsequent years.

The rates filed on August 1, 1968 were allowed by the Federal Power Commission to become effective on February 16, 1969 and have remained in effect until the present time. A rate increase to reflect the unavailability of accelerated depreciation could be delayed by the administrative process for up to nine months after the decision to file the increased rates. From February 16, 1969 until new rates are permitted to become effective, the Company would have suffered a non-recoverable loss of approximately $1,600,000 annually because of its reliance upon the use and flowthrough of accelerated depreciation as described above.

As further evidence that the Company had elected to take accelerated depreciation during 1968, we attach hereto the following:*

1. Annual Report to stockholders of Florida Gas Company for the year 1968. Note (3) to the Notes to Financial Statements at page 21 states that:

   "Concurrent with the completion in 1968 of its 192,000 MCF per day expansion, Florida Gas Transmission Company elected to claim liberalized depreciation for Federal income tax purposes on new facilities and to flow through the tax reductions to ratepayers, following an accounting method approved by the Federal Power Commission. Since there was a concurrent rate reduction, this change in accounting had no appreciable effect on net income for 1968."

   In its report on page 22 of the Annual Report, Arthur Andersen & Co. states that the accounting principles:

   ". . . other than for the flow-through of the tax reductions from using liberalized depreciation as described in Note 3, were applied on a consistent basis during the two years [1967 and 1968]."

2. Prospectus, dated April 10, 1969, with respect to the sale of Florida Gas Company's 5-3/4% Convertible Subordinated Debentures due April 1, 1989 wherein Florida Gas Company and Arthur Andersen & Co. make similar representations on pages 8, 14, 29, and 35 to those made in the Annual Report of Florida Gas Company.

3. Form 10-K, dated April 30, 1969, filed with the Securities and Exchange Commission, containing statements identical to those in the Annual Report of Florida Gas Company.

* The attachments referred to are made a part of the official files of the Committee.

In addition, on December 13, 1968, the Company filed its Amended Declaration of Estimated Income Tax for 1968 on the basis of depreciating its properties acquired subsequent to December 31, 1967 at accelerated rates for tax purposes. Also, registration statements filed with the Securities and Exchange Commission in May 1969, with respect to the Florida Gas Company Employees Savings Plan and the Florida Gas Company Qualified Stock Option Plan, contain statements with respect to accelerated depreciation similar to those contained in the Annual Report of Florida Gas Company.

For the above reasons, Florida Gas Transmission Company requests that subsection 167 (k)(1)(A) of the Internal Revenue Code, as proposed to be amended by Section 451(a) of House Bill 13270, be amended in one of the following manners:

1. Delete subsection (1)(A) and substitute the following:

   "(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer used a method other than the straight-line method in the calculation of income tax expense recorded in his regulated books of account for his latest monthly accounting period ending on or before July 22, 1969."

2. Delete subsection (1)(a) and substitute the following:

   "(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer <u>(i)</u> for his latest taxable year for which a return was filed on or before July 22, 1969, used a method other than the straight-line method, <u>or (ii) was, on July 22, 1969, collecting rates pursuant to rate schedules filed with a state or federal agency established by using a cost of service which included tax expense computed by using a method other than the straight-line method and used a method other than the straight-line method in his Federal income tax return for his latest taxable year ending on or before July 22, 1969."</u> (Changes underlined.)

3. Delete subsection (1)(A) and substitute the following:

   "(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer <u>(i)</u> for his latest taxable year for which a return was filed on or before July 22, 1969, used a method other than the straight-line method, <u>or (ii) had filed, on or before July 22, 1969, rate schedules with a state or federal agency wherein rates were established by using a cost of service which included tax expense computed by using a method other than the straight-line method and used a method other than the straight-line method in his Federal income tax return for his latest taxable year ending on or before July 22, 1969."</u> (Changes underlined.)

4. Delete the date "July 22, 1969" and substitute the date "September 15, 1969" therefor.

5. Delete the words "for which a return was filed" and insert in lieu thereof the word "ending" so that subsection (1)(A) would read as follows:

   "(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer for his latest taxable year ending on or before July 22, 1969, used a method other than the straight-line method, and".

6. Delete the word "filed" and insert in lieu thereof the words "initially due" so that subsection (1)(A) would read as follows:

   "(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer for his latest taxable year for which a return was initially due on or before July 22, 1969, used a method other than the straight-line method, and".

7. After the words "for which a return was filed on or before July 22, 1969" add "or on or before a subsequent date if a valid extension to file at such later date had been granted on or before July 22, 1969", so that subsection (1)(A) would read as follows:

   "(A) with respect to such property (or with respect to property of the same kind as such property) the taxpayer for his latest taxable year for which a return was filed on or before July 22, 1969, or on or before a subsequent date if a valid extension to file at such later date had been granted on or before July 22, 1969, used a method other than the straight-line method, and".

STATEMENT OF THE
EDISON ELECTRIC INSTITUTE
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON H. R. 13270

September 9, 1969

SUMMARY SHEET

1. We urge the elimination of an existing inequity in our tax structure and an increase in the Federal revenue by requiring presently tax-exempt electric power systems to pay Federal taxes equivalent to those now paid by tax-paying systems.

Since taxes are an operating expense of electric utility systems and since their rates must be fixed to cover all such expenses, the customers of government-owned and government-financed power systems, which do not now pay any Federal income taxes, escape the tax contributions which customers of the investor-owned systems are required to pay. We urge that this inequality and inequity in the discriminatory treatment of one group of citizens as against another should be eliminated.

2. We urge that Section 103 of the Internal Revenue Code be amended to except from interest exemption all bonds issued to acquire facilities used in the business of furnishing electric energy or in any other comparable business functions.

The furnishing of electric energy to the public is a proprietary or business function as is evidenced by the fact that approximately 78% of all electric customers in the United States are served by investor-owned companies. When Congress, in 1959, authorized TVA to issue revenue bonds to finance its electric power business, Congress expressly provided that the interest on such bonds would not be exempt from the Federal income tax. There is no valid reason why the obligations of a State or any political subdivision of a State, issued to finance the business of supplying electric energy, should be exempt from Federal income tax.

3. We urge that the Congress authorize State and local taxing authorities to impose on Federal power systems, on a non-discriminatory basis, the same State and local taxes as are levied on comparable investor-owned systems.

STATEMENT OF THE
EDISON ELECTRIC INSTITUTE
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON H. R. 13270

September 9, 1969

This statement is submitted by the Edison Electric Institute, which is the national trade association of the investor-owned electric power companies. Its 181 member companies serve approximately 78% of all electric customers in the United States.

The statement of the Edison Electric Institute at this time */ covers a proposal to eliminate an existing inequity in our tax structure and to increase the Federal revenue by requiring presently tax-exempt electric power systems to pay Federal taxes equivalent to those now paid by tax-paying systems and, otherwise, to achieve a greater degree of equality in the taxes imposed on electric power systems.

*/ In testifying before this Committee on the transition provisions of the investment credit repeal, included in H. R. 12290, the Institute urged deletion of the so-called phase-out in Section 49(d) which is in direct conflict with, and largely nullifies, a basic premise of the transition provisions -- i.e., to deal fairly with the taxpayer who entered into commitments on or before April 18, 1969 in reasonable reliance on the availability of the investment credit. We also urged clarification of the definition of a "certified pollution control facility", in Section 168(d) (1), to make it clear beyond question that such portion of a high stack at a generating station as is constructed solely for air pollution abatement may qualify for accelerated amortization. This testimony appears in Hearings Before the Committee on Finance, United States Senate, 91st Cong., 1st Sess., on H. R. 12290, July 15, 1969, at pp. 404-415. In accordance with the direction of the Committee we are not repeating this testimony at this time; our views on these points have in no way changed and we request they be taken into account by the Committee in its consideration of H. R. 13270.

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Discussion

There has been increasing emphasis on tax reform proposals for the elimination of existing tax inequities and the equal treatment of taxpayers similarly situated.

The imposition of disparate tax burdens on similar businesses represents a major area in which there is substantial tax inequity and discriminatory treatment.

In testimony before the House Ways and Means Committee on February 24 of this year, Mr. Mortimer Caplin emphasized this point and stated:

> "The tax immunity of exempt organization businesses produces substantial losses of federal revenues. Even more serious, however, is the fundamental problem of unfair competition. The businesses with which the exempt organization competes must pay taxes on their earnings. The exempt organization, on the other hand, can make a variety of effective uses of the additional funds which it derives from its exemption. It may cut its prices below those which are economically feasible for its competitors. It may reinvest its tax savings in capital improvement and expansion programs . . . It is, in sum, permitted to wage business competition with a major and often decisive advantage over other businesses." (Hearings on Tax Reform Before the House Committee on Ways and Means, 91st Cong., 1st Sess., pp. 968-9.)

The elimination of such tax inequities may have the additional salutary effect of broadening the tax base and increasing the Federal revenue in a significant amount.

In the broad field of tax inequity between similar businesses, one of the most flagrant instances of unequal tax treatment is in the electric power business.

Since taxes are an operating expense of electric utility systems and since their rates must be fixed to cover all such expenses, the end result is that customers of the tax-exempt power systems escape the tax contribution which customers of the non-exempt systems are required to pay.

The Edison Electric Institute urges that this inequality and inequity in the discriminatory treatment of one group of citizens as against another should be eliminated by requiring tax-exempt power systems to pay a Federal tax equivalent to the Federal taxes paid by the non-exempt systems.

The electric utility industry in the United States is comprised of the investor-owned systems which serve about 78% of all customers and the government-owned or government-financed systems which serve the other 22%.

Investor-owned electric systems are, of course, subject to the Federal income tax and pay State and local taxes which, in most cases, are higher than those paid by other businesses.

The government-owned and government-financed systems pay no Federal income tax whatever and their State and local taxes, or payments in lieu of taxes, are a great deal lower than those paid by investor-owned systems.

Total taxes of the investor-owned electric utilities for 1968 are estimated at $3,484,000,000, of which $1,763,000,000 are for Federal tax. These total taxes represent 22% of operating revenues.

By way of contrast, total taxes of government-owned and government-financed power systems are estimated for 1968 at approximately $130,000,000, representing about 3-1/2% of their electric revenues, not one cent of which was paid in Federal income taxes.

In other words, the government-owned and government-financed power systems -- which represent about one-quarter of the total industry -- accounted for only about one-thirtieth of the total tax bill of the industry and made no payment whatever of Federal income taxes or the equivalent.

As indicated in the attached Table, it has been estimated that, in 1967, the Federal, State and local governments lost over $900,000,000 in taxes as a result of the preferential tax treatment of government power systems; and that the total tax revenue lost by preferential treatment, in the period 1953 through 1967, is over $10 billion.

If government-owned and government-financed power systems were required to pay Federal taxes equivalent to the Federal income taxes imposed on investor-owned companies, on the basis, for example, of an equivalent ratio to plant investment, it is estimated that such Federal taxes would have amounted to over $500 million in 1966, and for the last 10 years to over $4 billion.

There are four western European countries which have both investor-owned and government-owned power systems. It is interesting to note that, in those countries, an obvious effort has already been made to minimize the difference in the tax burdens imposed on the different segments of the industry; and the disparity in taxes, as between investor-owned electric companies and government agencies, is far less than that in the United States. The tax burden on investor-owned systems in the United States in

1966, computed as a percentage of gross revenue, was about 7 times the tax burden of government-owned and government-financed systems. In 1965 (the latest year for which figures are available) the comparable factor in Finland was 2.25; in Germany, 1.2; in Norway, 1.25; and in Sweden, 1.76.

It is particularly important to emphasize again that, in the electric utility business, taxes are an operating expense which must be included in rates so that the tax inequity is, in fact, carried over to a highly disparate treatment of the individual customers of the investor-owned utilities, on the one hand, and those of the government-owned and government-financed power systems, on the other.

It is submitted that it is obviously unfair for the 78% of the electric customers in the country, who are served by the investor-owned power systems, to pay almost 7 times as much in their rates to cover tax costs as is paid by the 22% served by the government-owned and government-financed systems. */

*/ The Province of Alberta, Canada, has recently faced up to this problem. To put customers of investor-owned utilities on an equal footing with those of the tax-exempt government-owned systems, it has authorized payment from its Treasury to the customers of investor-owned utilities of $9 million. This amount represents something over 95% of the Federal and Provincial income taxes paid by the investor-owned utilities in the year in question.

This is, of course, another approach to achieving tax equality in the treatment of one group of citizens as against another. The Edison Electric Institute believes, however, that, having due regard to the need for the tax revenue, the more appropriate approach in this country is to require the tax-exempt power systems -- and their customers -- to bear an equivalent tax burden to that now imposed on the investor-owned power systems -- and their customers.

Unless something is done to eliminate this inequity, the tax disparity among users of electricity will continue year after year and will become even greater. As the favored government-owned and government-financed power systems continue to expand, they will grow at the expense of all the country's taxpayers and further emphasize the unfair discrimination. Where two groups of America's electric customers, distinguishable only by the source of electricity, bear highly unequal tax burdens, tax inequality exists which deserves the attention of this Committee and the Congress.

Proposed Solutions

1. A start in the direction of achieving tax equality among power suppliers, and increasing the Federal revenue, can be made by imposing a tax on the activities of government-owned and government-financed power systems in generating, transmitting or distributing electric energy. Such tax should be at a specified rate, applied to a base measured by gross plant investment or by electric revenues, which rate should be comparable to the ratio of Federal income taxes paid by investor-owned systems to their plant investment or electric revenues. Federal agencies, such as the Federal Power Commission, now have all the necessary statistics to derive the required figures.

Such a tax should be imposed on cooperative systems without regard to whether they allocate their profits or so-called "margins" to their members or patrons. In the light of the emphasis on the non-profit character of the electric power cooperatives, it may be of some interest to note that the "net margins" of electric power cooperatives in 1968 -- i.e., the amount available after deducting all expenses, taxes and interest charges -- amounted to over $129 million -- on which not one cent of Federal taxes was paid by either the cooperatives or their customers.

2. There are a large number of State, municipal and other local governmental power systems. Interest on their obligations issued to finance such power systems is exempt under Section 103(a) of the Internal Revenue Code. Recently, certain of these governmental agencies have financed electric power operations through the issuance of industrial development bonds -- generally for the purpose of furnishing electric energy to large industrial customers. Exemption of the interest on such bonds is claimed under Section 103(c).

The furnishing of electric energy to the public is not a governmental function, but is rather a proprietary or business function, as evidenced by the fact that approximately 78% of all electric customers in the United States are served by investor-owned companies. It is significant that, when Congress, in 1959, authorized the Tennessee Valley Authority to issue revenue bonds to finance the electric power business of TVA, it expressly provided that the interest on such bonds would not be exempt from the Federal income tax. There is no valid reason why any other governmental agency should be permitted to use tax-exempt bonds to finance facilities used in the business of supplying electric energy.

Secion 103 should be amended to except from interest exemption all bonds issued to acquire facilities used in the business of furnishing electric energy or in any other comparable business functions.

3. A further step which, in our view, ought to be taken to reduce existing tax inequality among similar businesses is for the Congress to authorize State and local governments to impose on Federal power systems, on a non-discriminatory basis, the same State and local taxes as are levied on comparable investor-owned systems.

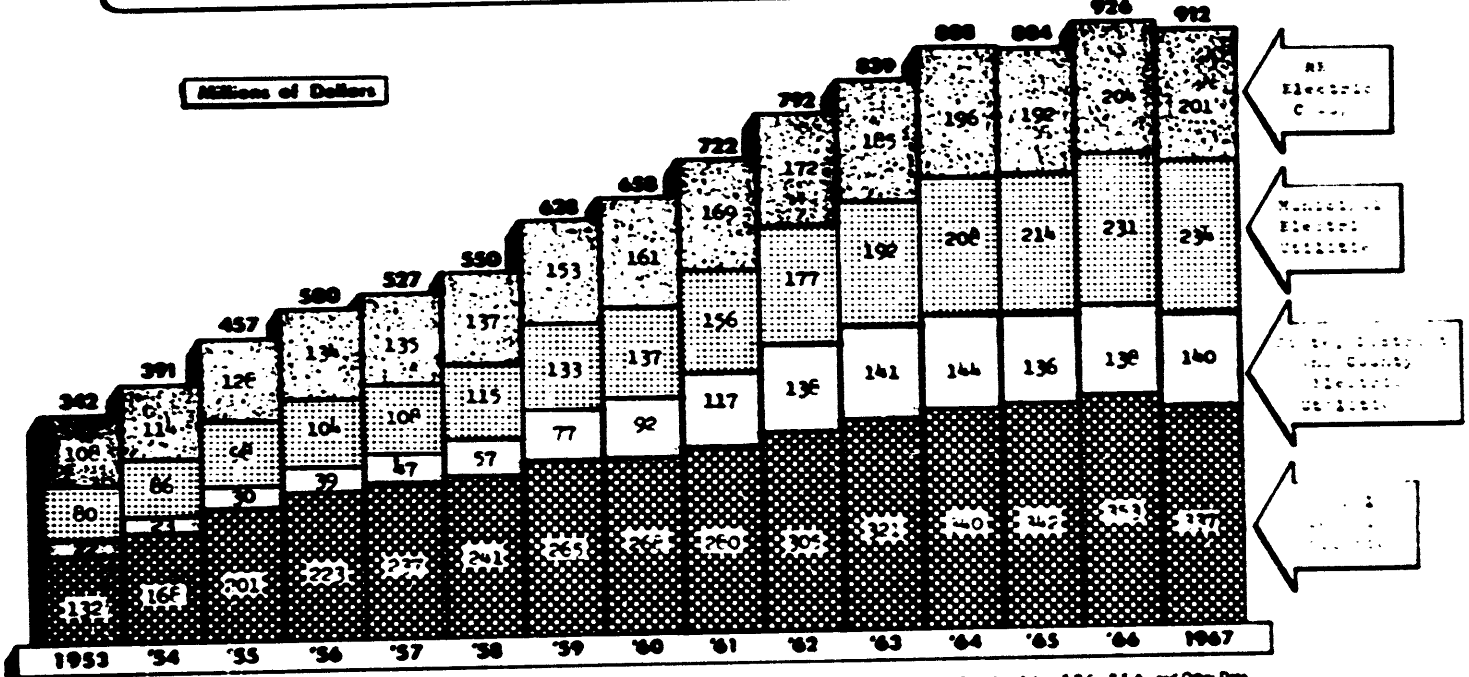
Conclusion

Government-owned and government-financed power systems engaged in the business of furnishing electric power -- and their customers -- should be required to make comparable contributions in taxes to those required of investor-owned power systems -- and their customers. We urge that now, when one of the facets of tax reform being studied is the elimination of tax disparity among similar businesses, it is time to act to eliminate or at least reduce the tax inequities which exist in the vital electric utility industry.

Such action would achieve the highly salutary objectives of (1) eliminating or reducing an existing inequity between customers of the investor-owned segment, on the one hand, and customers of the government-owned and government-financed segment, on the other; (2) reducing the disparity in tax treatment between similar businesses; and (3) broadening the tax base and increasing the Federal revenue in a significant amount.

Trend in Estimated Annual Taxes Not Paid by Government-Owned or Financed Electric Utilities...

Total taxes not paid during period 1953-1967 = $10,016,000,000



Based on Ratio of Taxes Paid by Taxpaying Electric Power Companies On Electric Plant in Service and Construction Work in Progress

AMERICAN TELEPHONE AND TELEGRAPH COMPANY

195 BROADWAY NEW YORK N Y 10007

AREA CODE 212 393-9800

September 24, 1969

Honorable Russell B. Long
Chairman
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman

This statement is respectfully submitted on behalf of the Bell Telephone System in favor of the public utility tax depreciation provisions as set forth in Section 451 of H.R. 13270.

The report of the Committee on Ways and Means accompanying H.R. 13270 discusses the background and need for legislation along the line of proposed Section 451, and I will limit my comments to a summary of the highlights of this background as it affects A.T.&T and its operating telephone companies.

Briefly stated, we are convinced that the proposal is in the best interests of our customers and the Federal Treasury. We believe this bill, which directly involves a matter of tax policy, has been well designed to accomplish its purposes and does not infringe on regulatory authority.

We are vitally interested in these provisions because, as a capital-intensive industry, the Bell System companies must invest -- and recover through depreciation -- large amounts for the replacement, modernisation and expansion of communications plant to meet public demand for service. The Bell System construction program this year calls for expenditures of about $5.7 billion, with every indication that the need in 1970 will be greater.

Proposed Reform Provides Working Capital in Accord with Congressional Intent

Section 451 of H.R. 13270 is a reform measure which will assure that the original purpose of Congress, when it authorized accelerated tax depreciation in 1954, will be carried out substantially for the regulated sector of the economy as it is being fulfilled in the unregulated sector.

The declared purpose of Congress in 1954, when it initially authorized accelerated tax depreciation under Section 167 of the Internal Revenue Code, was to make working capital available to all American industry -- regulated as well as unregulated -- to encourage modernization and expansion of industrial capacity. This purpose was clearly stated in the Congressional reports, including that of the Senate Finance Committee, accompanying the original enactment of Section 167.[1]

In the case of non-regulated industries the accelerated tax depreciation provisions of Section 167 operate as Congress intended and produce working capital for these industries in one of two ways. First a non-regulated company may use accelerated depreciation not only for tax purposes but also for book purposes and to reflect the effect in its earnings. When this is done, tax payments are lower, cash flow is increased and outside capital requirements are thereby reduced. Another way a non-regulated company can obtain working capital is to use straight-line depreciation for book purposes, accelerated depreciation for tax purposes and reflect the reduction in current tax payments in a reserve to allocate tax costs properly over the life of the property. This procedure is known as "normalization" and is required by the accounting profession and the Securities and Exchange Commission for all non-regulated industries when faster depreciation is used for tax purposes than for book purposes.

For a significant number of regulated public utilities, however, the accelerated tax depreciation provisions of Section 167 have not been accomplishing their purpose. Since regulatory

1. S. Rep. No. 1622, p. 26. See also H. Rep. No. 1337, p. 24 (83d Cong. 2nd Sess.)

commissions generally require utilities to use straight-line depreciation for book purposes, only the second method mentioned above is available to public utilities that wish to obtain working capital in this manner. However, many regulatory agencies will not permit the 'normalization' procedure which, as indicated above, is required by the accounting profession and the S.E.C. in the case of non-regulated industry. Rather, they require the utilities under their jurisdiction to use an exception to this procedure, known as 'flow-through'. Under "flow-through" the cash flow generated by accelerated tax depreciation can be used to subsidize rates charged to current utility customers rather than to create a reserve of working capital. When this occurs, the cash flow generated by the use of accelerated tax depreciation does not generate a source of capital that Congress intended to provide under Section 167.

Any short-term benefit to current utility customers from "flow-through" is at the expense of future utility consumers and impairs the financial position of utilities by burdening them with large amounts of unprovided-for costs. For these reasons, Bell System companies -- even though they have had pressing and increasing needs for large amounts of capital to provide the communications needs of the country and have wanted to obtain capital by using accelerated tax depreciation -- have to date used for tax purposes the same straight-line depreciation method prescribed by the F.C.C. for book and rate-making purposes.

In a time of rapidly expanding national need for utility services, accompanied by unprecedented demands for utility investment capital, Section 451 of H.R. 13270 will afford all present straight-line and present normalizing utilities the same opportunity as nonregulated industry to obtain working capital from the use of accelerated tax depreciation, thus enabling those utilities to compete on the same terms as non-regulated industry in the capital markets.

Utility Consumers Benefit

Section 451 of H.R. 13270 also serves to assure in the case of present straight-line utilities -- thus, including Bell System companies -- and also in the case of present normalizing companies, that the full benefits of accelerated tax depreciation will go to customers both present and future.

There is a widespread belief that utility consumers are better off under flow-through than under normalization. The fact is, however, that the difference between flow-through and normalization, so far as utility rate payers are concerned, is simply which particular utility customers get the benefit and when. Flow-through treats the entire reduction in current tax payments as available to reduce rates to today's customers. But it has been demonstrated that utility revenue requirements -- and thus rates charged utility customers -- become greater after a period of time under flow-through than they would be under normalization. Flow-through, in sum, gives a windfall benefit to today's customers to the detriment of tomorrow's customers.

With normalization, on the other hand, there is a savings in capital costs to utility consumers because they do not have to pay interest or other charges for these capital funds used in providing utility service. Moreover, reduced demand on the money markets may tend to lower the costs of the remaining external financing requirements. Under Section 451, regulatory agencies would have full authority to see that the normalization reserve is used as cost-free capital, and that the full benefit of this cost-free capital is given to utility customers. If the Bell System companies could normalize, they have made it clear they would use the reserve for the benefit of customers, passing savings in capital cost on to customers over the entire period the working capital is used in their behalf. No Bell System customer would be called on to pay higher charges because the cash flow from accelerated depreciation had been used to subsidize rates of earlier customers; all Bell System rate payers would receive an increasing benefit as the cost of capital is reduced.

Federal Tax Revenues Are Protected
Against Unintended Loss

Section 451 of H.R. 13270, in addition, will tend to increase Federal tax revenue levels. The Report of the Ways and Means Committee estimates these increased tax revenue levels annually at $60 million in 1970, $260 million in 1974, and $310 million in 1979.

These increased tax revenue amounts derive directly from the effect of "flow-through" on utility Federal income tax payments. The result of "flow-through" in general, as pointed out by the House Report, is to double the Government's revenue reduction in the early life of plant when measured against that which is contemplated to result directly from granting accelerated tax depreciation allowances to industry. Normalization, largely, avoids this doubling effect.

As mentioned above, Bell System companies to date have used the straight-line depreciation method for Federal income tax purposes. However, regulatory and other pressures have reached the point where the Bell System no longer has any practical choice but to adopt accelerated tax depreciation. Moreover, some regulators are imputing accelerated tax depreciation with "flow-through" on companies even though the companies are in fact using straight line tax depreciation. If legislation applying to present straight-line companies along the line of Section 451 of H.R. 13270 were not to be enacted, and Bell System companies were forced -- as they inevitably would be by regulatory pressures -- to adopt accelerated tax depreciation with "flow-through", the reduction in their tax payments for 1970 would be about $110 million, (assuming accelerated tax depreciation is taken only on plant placed in service after December 31, 1969), or some $55 million greater than the estimated reduction in their tax payments under normalization for 1970. If legislation along the lines of Section 451 of H.R. 13270 covering present straight line utilities were enacted into law, the Bell System companies would expect to take accelerated tax depreciation on plant added in 1970 and subsequent years with "normalization".

In our view the provisions of Section 451 of H.R. 13270 are in the public interest, and I urge that they receive the Committee's favorable consideration.

Respectfully yours,

A L Stott

A. L. Stott
Vice President and Comptroller