91st Congress }
1st Session }

COMMITTEE PRINT

TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED MONDAY, SEPTEMBER 15, 1969

PART B—ADDITIONAL STATEMENTS

(Topic: Financial Institutions)

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

SEPTEMBER 13, 1969

S0990

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
33-756 O WASHINGTON : 1969

BEST AVAILABLE COPY

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

CLINTON P. ANDERSON, New Mexico
ALBERT GORE, Tennessee
HERMAN E. TALMADGE, Georgia
EUGENE J. McCARTHY, Minnesota
VANCE HARTKE, Indiana
J. W. FULBRIGHT, Arkansas
ABRAHAM RIBICOFF, Connecticut
FRED R. HARRIS, Oklahoma
HARRY F. BYRD, Jr., Virginia

JOHN J. WILLIAMS, Delaware
WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
EVERETT McKINLEY DIRKSEN, Illinois
JACK MILLER, Iowa
LEN B. JORDAN, Idaho
PAUL J. FANNIN, Arizona

TOM VAIL, *Chief Counsel*
EVELYN R. THOMPSON, *Assistant Chief Clerk*

CONTENTS*

PART A—WITNESSES

Financial Institutions

	Page
The Honorable Preston Martin, Chairman, Federal Home Loan Bank	1
Willis W. Alexander, President, the American Bankers Association	11
Charles H. Ogilvie, Chairman, National Association of Business Development Corporations	35
George C. Williams, President, National Association of Small Business Investment Companies	48
Arthur Roth, chairman, accompanied by I. Shirley Tark, cochairman, Bankers Committee for Tax Equity	51
Edward P. Clark, chairman, Committee on Taxation, National Association of Mutual Savings Banks	59
George L. Bliss, president, Council of Mutual Savings Institutions	93
C. R. Mitchell, legislative chairman, U.S. Savings and Loan League	103
D. William Overton, National League of Insured Savings Associations	119
Franklin Hardinge, Jr., executive vice president, California Savings and Loan League	138

PART B—ADDITIONAL STATEMENTS

D. H. Burlage, President, Norfolk Industrial Loan Association	147
Elizabeth H. Kury, Esq., Kury and Kury, Sunbury, Pa	153
J. Austin White, J. A. White & Co., Central Trust Tower, Cincinnati, Ohio	159

*This contents refers to the page numbers supplied by the printer. These numbers appear at the bottom of the page.

Testimony on H. R. 13270
Before the
Committee on Finance, United States Senate
September 15, 1969
by
Preston Martin*

Mr. Chairman and Members of the Committee:

It is a privilege to appear to testify on H. R. 13270. I will confine my remarks to the taxation of savings and loan associations.

SUMMARY

The Federal Home Loan Bank Board ("Board") urges the enactment of a tax incentive on residential real estate loans: a deduction based upon a percent of gross interest income from these loans, the so-called Administration proposal.

The Board further suggests the consideration by this Committee of a stronger incentive on the same deduction basis, based on gross mortgage income derived from conventional mortgage loans to moderate and low income households. If the Administration's "5 percent deduction" is adopted, the Board requests consideration of a 10 percent deduction for gross income so derived.

FHLBB opposes the tax definition of a savings and loan association contained in H. R. 13270. H. R. 13270 first describes a savings and loan as an insured institution or one which is subject to regulatory supervision and examination. The Board believes that this is an adequate definition and that to go further inhibits the adaptability of the savings

*Chairman, Federal Home Loan Bank Board

and loan industry in a changing environment.

The present application of the tax law to "supervisory" mergers has been in need of revision. Under current tax law, tax deducted reserves may be subject to recapture upon merger or acquisition of assets. Where this is the case, the tax would be taken from existing net worth, and this estops the merger. The Board believes that, at a minimum, "supervisory" mergers or acquisitions of assets instituted by it in the public interest should be relieved of this tax effect.

Tax Reform and Inner-City Investment

This Board appreciates that the Committee, the Congress, and the Administration must act as Solomon in balancing the revenue needs of the Nation with the potential impacts of tax legislation upon the means for obtaining our many national goals. Housing is and should be paramount among these goals, and housing for moderate and low income households is a goal which is fundamental to our social stability. The Board supports the tax deductions approach based upon a percentage of gross interest income in the taxation of savings and loans. It does so because the deduction approach has those virtues of simplicity and clarity in contrast to the complications and ambiguities of the present "bad debt reserve" approach. The deduction approach has the social virtue of widening the incentives for residential lending to non-savings and loan institutions. Financing the great housing needs of this Nation in the 1970's of something like 26 million additional units and tens of millions of sales transactions necessary in the existing inventory to move the new units

is a task of such Herculean magnitude that all lending institutions should be stimulated to participate.

The Board is in present dialogue with the Treasury as to considerations of the 5 percent deduction rate, its phase-in curve over time, and the deduction percentage which may be recommended as additional incentive for uninsured, unguaranteed loans to moderate and low income households.

I respectfully ask that the Board be granted the privilege by the Committee of submitting a supplementary statement of the above issues prior to the closing of these Hearings.

FHLBB is certain that H. R. 13270 lacks specific incentive to lending institutions of all kinds for funding the development and redevelopment of Inner-City and other urban housing for moderate and low income Americans. The Board would argue that there are few more pressing, essential needs than housing for these Americans. A most frequently overlooked social relationship is the high correlation between better housing, productivity and social stability. Again and again in our history, ethnic groups have exhibited the upward social mobility which has contributed so much to our culture and our national strength. A better job may be the first step but a better apartment and then a house of your own is certainly the second one. That apartment or that house, in turn, increases a sense of family unity and spurs an adult member of the family group to great economic incentive to further material goals.

H. R. 13270 has a number of tax incentives to individuals and to investors in housing. I respectfully ask you to consider how we are going to stimulate large amounts of housing if the incentive is only to that individual or corporation which puts up 5 percent or 10 percent of the development cost, while the financial institution putting up 90 percent or 95 percent (often 100 percent), before the project is completed, has no specific incentive at all. The Federal Home Loan Bank System is currently advancing funds to member institutions so they can finance FHA projects in Inner-Cities. There is not even adequate money for these insured risks at this time. Certainly there will not be funds for quicker, more flexible approaches of the private lender for his community where Federal guarantees and insurance do not have to be waited for. A more generous tax deduction such as 10 percent would do much to provide incentives in this necessary area.

Tax Definition of a Savings and Loan

H. R. 13720 proposes to re-enact -- with modifications -- the existing tax definition of a savings and loan association.

H. R. 13720 first describes a savings and loan as an insured institution or one which is subject to regulatory supervision and examination. The Board believes that this is an adequate definition and all that is needed is the tax law. To go further inhibits the ability of the industry to adjust to changing consumer demand structures.

The Friend Study, recently completed, has shown that the economics of the industry are changing dramatically and will continue to change in the short term. While the industry has grown throughout the postwar period, profitability has declined from 12.5% of net worth in 1962 to 4.1% in 1967. During this same time period, the rate of growth of associations' deposits has continually declined. By the mid-1960's, it was well below that of commercial banks.

Due to the long-term nature of the mortgage instrument, savings and loans cannot adjust to market interest rate changes. In view of their large holdings of older low-interest mortgages, many associations are not always in a position to raise new money whenever it is needed. To counteract this, the Friend Study has suggested that greater flexibility be introduced into association asset-liability structures. They are now borrowing short-term money and lending long-term funds. In order to allow associations to compete with commercial banks for funds, Friend argues that this asset-liability imbalance must be corrected.

33-758 O-69—No. 4—2

Friend also found that there are pronounced economies of scale in the financing of residential mortgages by associations. This leads to the conclusion that mortgage lending can be handled more efficiently by specialized institutions like savings and loan associations, than by diverse institutions like commercial banks.

All of this evidence of changing economics leads the Board to believe that less rigid definitions are needed rather than more stringent ones. Rigid definitions of permissible asset percentages also place the Congress in an awkward position. On the one hand Congress rightly charges the FHLBB with certain authority to regulate the savings and loan industry in the public interest. On the other hand, in a search for revenue, it overlaps that authority by imposing a certain rigid limit like the "82% rule."

H. R. 13270 does not stop here, but rather goes on to describe specifically the business and activities of a savings and loan: "substantially all of the business of which consists of acquiring the savings of the public and investing in loans." This re-codification of an apparently "practical" provision presumably continues in effect certain Treasury regulations which may conflict seriously with the Board's housing policy objectives. During periods like 1966 and 1969 of rising interest rates and low savings inflows, long-term lenders should be encouraged to maintain a relatively high velocity of cash flow -- to serve their borrowing public -- this is generally possible only through a vigorous loan sales or participation program which turns over the mortgage inventory. The "investing in loans" requirement is directly counter to this basic policy objective.

Based on the language of the savings and loan "definition", the Treasury in 1964 published certain tests -- the "gross income" test and the

"sales activity" test -- to determine whether an association was "investing in loans" as required by the statute. The "gross income" test was conceived when the industry apparently was extremely profitable and was designed to limit availability of the savings and loan tax shelter to income generated by the traditional savings and loan activities. The test is met if 85 percent of an association's income is normal savings and loan operating income. Not only is the test difficult to administer, but an association could be forced beyond the allowable limit by the FHLBB or perhaps a counterpart state regulatory authority -- as when required to develop or sell excessive real estate holdings. In many cases, the requirement tends to encourage management decisions which are not in the best long-run interests of the institution.

The "sales activity" test has further onerous consequences. The test was designed to limit an association's ability to sell loans or loan participations even though the sale may have resulted from an excess of demand for loans over savings capital in the association's geographical area. Such a restriction directly conflicts with the public objective of furthering optimal geographical allocation of funds. With a forecast overall shortage of mortgage capital over the next decade, it seems all the more important that the barriers to such funds flows should be removed.

Finally, the proposed tax definition in H. R. 13270 sets forth an elaborate structure as to the mix of assets which a savings and loan association must hold. An association must fall within this framework to maximize its bad-debt deduction. The Board sees no need for any "asset test", in the presence of regulatory limitations for Federally-chartered associations and cease-and-desist powers to prevent unsafe or unsound concentrations

of investment in nontraditional types of assets, (generally the types which are now limited in the Board's regulations).

There is a further reason. The "asset tests" included in H. R. 13270 probably would be difficult to change during the next decade. Who can say today what asset will be in the public interest during the 1970's in order to optimize the savings and loan industry's contribution to housing? Mobile home lending is an example of the "forbidden asset" of the 1960's, one of sudden strong growth and of moderate income service ability. With hindsight one could now argue that both the tax law and the National Housing Act should have been changed earlier in recognition of the social need for this type of housing. The Board respectfully submits that Congress and the Board will have a better posture from which to respond to changing circumstances or, perhaps more importantly, to anticipate a need for change without detailed enumeration of assets.

The Treasury proposal would effectively solve most of the problems created by the existing law and those which would be continued by H. R. 13270.

Mergers

The present tax law -- as it applies to the mergers of savings and loan associations -- makes the "supervisory" merger in many cases very difficult or impossible. Let me explain what I mean by a "supervisory" merger as opposed to a "business" merger. A "supervisory" merger is encouraged or instituted in the public interest by the FSLIC and the FHLBB, involving one or more savings and loans with financial or managerial problems. A "business" merger is initiated by member savings and loans for objectives like economies of scale or market entry.

Business merger applications are approved or disapproved by the Board depending upon a variety of criteria (such as whether the interests of the consumer -- both the saver and the mortgage borrower -- are better served by larger size competitors).

It is the application of the tax law to the "supervisory" merger which concerns the Board. The problem is that under current tax law -- including Section 593(f) -- tax deducted reserves may be subject to recapture; and, if this is the case, the tax must be taken from existing net worth which is usually already too thin. This effectively bars some otherwise desirable merger candidates or unduly limits the available supervisory solutions.

First, in a so-called non-taxable or tax-free reorganization -- two mutuals merge or two stock associations merge and no cash changes hands -- the supervisory agencies usually insist that the parties obtain an Internal Revenue Service ruling that there will be no restoration of the reserves under 593(f). Such a ruling is vital because adverse tax consequences would be disastrous to the adequacy of net worth. However, obtaining a tax ruling is a time-consuming task and in a supervisory merger time can be of the essence.

Therefore, the Board recommends that the tax law be amended to state that there would be no recapture of reserves in a tax-free reorganization for clarification, even though the Service recently published a ruling which supports the conclusion that there is no restoration required in non-taxable mergers.

However, the Board is even more concerned that current tax law would (at least in the Internal Revenue Service's view) subject a savings and loan's reserves to tax in the supervisory merger of a stock association into a mutual or vice versa -- even when there is no economic gain to the disappearing shareholders and almost certainly no gain to either of the corporate parties to the merger. This rule in effect eliminates the possibility of a supervisory merger of a "problem" association -- either a stock or mutual -- into a stronger association which does not operate under a similar charter.

The Board would propose to allow the acquired association to carry over its tax deducted reserves in a supervisory merger provided the consideration paid for the acquired association either: (1) flows from the tax paid earnings of <u>either</u> association, or (2) from a non-savings and loan association such as a holding company. However, in no event should there be recapture in excess of the cash consideration paid for the savings and loans. In such a case, the recapture potential would carry over to the acquiring association; but there would be <u>no</u> current tax impact or reduction in net worth thereby .... which is in the public interest.

The Administration proposal, over time, would tend to minimize this problem. Perhaps at some appropriate time a complete examination of the nature of savings and loan reserves and net worth could be undertaken with the objective of clarifying thenature of such accounts and the circumstances under which they may be subject to tax.

SUMMARY OF THE PRINCIPLE POINTS OF THE TESTIMONY OF WILLIS W. ALEXANDER ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION BEFORE THE SENATE FINANCE COMMITTEE ON H. R. 13270

SEPTEMBER 15, 1969

Gains From Debt Securities

1. The ordinary income treatment of security gains and losses by banks would hamper the efficient management of the public debt.

2. The market effects of the proposed tax treatment have already decreased demand for low coupon issues and decreased the demand for intermediate and longer term issues.

3. Should Congress terminate this present treatment of capital gains and losses, the cost of Treasury and municipal intermediate and long-term financing is quite likely to increase and may well result in greater cost than the increase in revenue involved.

4. Banks and other institutions are experiencing a further depreciation in the values of their security holdings which may impair their margins of solvency.

5. The present nonsymmetrical treatment of capital gains and losses at banks enables the banking system to meet changing credit needs in the economy.

6. If Congress terminates the present treatment, it should not be made retroactive, since banks presently own securities which they had purchased before the July 11 announcement date of the proposed legislation in the belief that gains would not be taxed as ordinary income.

Bad Debt Reserves

1. The present treatment of bad debt reserves of banks is the result of prolonged and intensive discussions between Treasury officials and banking industry representatives on what constitutes an adequate reserve for protection against loan losses.

2. Current provisions for bad debt reserves provide stability and solvency to the banking system and recognize the need for different treatment from that accorded commercial enterprises. In other legislation, the Congress is now grappling with the question of the difference between commerce and banking.

3. Without an adequate bad debt reserve, banks experiencing heavy losses on loans could suffer impairment of capital sufficient to force liquidation or reorganization. Current public policy requires stepped up marginal lending with respect to risk and net returns to solve some of our inner city and other problems. This calls for strengthened, not weakened, bad debt reserves.

4. The question of net returns on economic income as a result of investment in municipal issues is not relevant to the matter of bad debt reserves. Moreover, such investment is also dictated by deliberate bank policy to help in financing State and local Governments.

5. The proposed carry-back and carry-forward treatment of losses does not provide the same degree of protection as an established reserve.

Provisions Affecting the Trust Industry

1. Sections 341 and 342 relating to accumulation trusts should not be enacted because tax abuse is not a problem and the possibility of tax avoidance is slight.

2. Section 201 requiring the establishment of an annuity trust or unitrust to obtain a charitable deduction should not be enacted because the statutory approach is extreme; it would reduce the investment flexibility of trusts and impose unnecessary burden and expense on trustees.

3. Section 515 relating to the taxation of lump sum distributions from qualified employee death benefit plans should not be enacted because present capital gains treatment is equitable and the income received is important to family security when the family breadwinner dies.

Withholding of Interest and Dividends

1. Passage of this amendment would place an unnecessary burden and expense on banks and other payers of interest and dividends.

2. The Internal Revenue Service has a vast amount of data from information returns on Form 1099 filed by banks and other payers of interest and dividends that can be used to determine taxpayers' liability, which in all likelihood has not been used. The Service should use this information before requiring private industry to withhold taxes on interest and dividends.

STATEMENT OF WILLIS W. ALEXANDER
ON BEHALF OF
THE AMERICAN BANKERS ASSOCIATION
BEFORE THE
SENATE FINANCE COMMITTEE
ON
H. R. 13270

September 15, 1969

* * * * * * *

Mr. Chairman and members of the Committee, I am Willis W. Alexander, President of the Trenton Trust Company, Trenton, Missouri, and President of The American Bankers Association. I appreciate this opportunity to testify for the Association on the Tax Reform bill (H. R. 13270). This bill in its entirety and the changes proposed by the Secretary of the Treasury are of interest to the banking community. Federal taxation and expenditure are major forces influencing the growth, stability, and efficiency of our economy. The challenge to Federal fiscal policy today is to achieve an ordering of national priorities that is consistent with attainment of the maximum rate of real economic growth that can be sustained without inflation. The American Bankers Association has consistently supported fiscal measures aimed at curbing inflation and at assuring orderly growth of our economy. As much as we would like to comment extensively on the Tax Reform bill, the limitations of time and the urgency with which this bill is being considered dictate that we limit our testimony today to provisions in the bill which are of particular concern to the commercial banking industry.

Gains From Debt Securities

At the present time, commercial banks, along with mutual savings banks, savings and loan associations, and small business investment companies, receive nonparallel treatment with respect to capital gains and losses on

debt securities. Net gains are taxed as capital gains; net losses are deducted from ordinary income. Under the Tax Reform bill, both net gains and losses would be treated as ordinary income.

In its report on the Tax Reform bill, the Committee on Ways and Means noted that the "nonparallel treatment of gains and losses on bond transactions was adopted in 1942 to encourage financial institutions to support the large new issues of bonds which were then being offered to help finance the war." The history of special treatment of losses on sales of debt securities by banks dates back prior to World War II, but there is little question that the exigencies of wartime finance were the major consideration in the legislative establishment of the nonparallel treatment of gains and losses in 1942.

The present treatment of gains and losses is not an omission or "loophole" where none was intended by the Congress. The argument for reform would appear to rest upon the idea that public policy objectives have long since been achieved. We do not believe this to be the case. The Treasury faces a large and difficult task in the management of the Federal debt, and there is cause for concern that the bond gain provisions will have an adverse impact on the debt securities markets.

Just the prospect of the termination of the nonparallel treatment of gains and losses has already largely had three effects: (1) A decrease in demand for long-term and intermediate-term issues relative to demand for short-term issues. (2) A decrease in demand for issues with low coupon rates relative to demand for issues with high coupon rates. (3) A reduction in the already low liquidity of the banking system. These effects work in the direction of widening swings in prices, which increase the market risk of holding Government securities.

It is elemental that increased risk of fluctuations in the price of a bond means that higher rates of interest must be paid in order to attract purchasers. Moreover, in the face of increased risk of price fluctuations, investors tend to shift to shorter term issues, on which the potential loss due to fluctuations in price is less than on longer term issues. Hence, elimination of nonparallel treatment of gains and losses will increase the difficulty of the Treasury and state and local governments in issuing intermediate and long-term securities, and will also tend to increase the cost of such financing.

There is little or no basis for estimating the extent of the effect upon cost and average maturity. However, as the pricing mechanism in the Government securities market is a highly efficient one, prices can be expected to adjust to reflect any advantage lost in the termination of nonparallel treatment of gains and losses. The net effect could well be that increased costs of Treasury financing will in due time offset the increased revenue resulting from the taxation of securities gains as ordinary income.

The impact upon the present liquidity of the banking system comes from the fact that termination of the present treatment of gains reduces the effective yield of issues now outstanding and selling below face value. These yields have already largely been brought into line with market rates of interest in general, through declines in the prices of the affected issues. Thus, banks as well as other financial institutions are experiencing further depreciation in the market value of their holdings of securities. The result will be further impairment of the liquidity of these institutions and further impairment of their margins of solvency.

The impact upon liquidity and solvency will, of course, be a transitory one, but it could be a relatively significant one under the presently

stringent financial situation. The effect upon the costs of Treasury financing will be long term as well as immediate.

We attach sufficient significance to the long-term effects upon Treasury financing to believe that there continue to be valid public policy objectives for maintaining nonparallel treatment of gains and losses. Moreover, nonparallel treatment has served to facilitate the meeting of credit needs in periods of economic expansion. To obtain funds to meet credit demands, banks must frequently sell securities when prices are depressed. The taking of losses under such circumstances is, in part, mitigated by the prospect that after credit demands slacken, funds can be reinvested in securities which will appreciate in value, thereby providing capital gains. That is, the prospect of future gains, taxable as capital gains rather than as ordinary income, will encourage banks to take the security losses necessary to meet credit demands. Nonparallel treatment of gains and losses has thus enhanced the responsiveness of the banking system in meeting changing credit demands of the economy.

Our last but very essential point with respect to the nonparallel treatment of gains and losses is that termination of such treatment should not be retroactive. That is, it should not alter the effective yields of securities now held by commercial banks and other financial institutions accorded such treatment. Present holdings of securities were acquired on the basis of yields calculated to include capital gains treatment of the difference between purchase price and face, or redemption, value. It would be inequitable to reduce the effective yields of securities acquired in good faith on the expectation that gains would not be taxed as ordinary income. If nonparallel treatment is eliminated, the legislation should apply only to securities acquired after July 11, 1969, when the proposed change

was announced by the House Ways and Means Committee.

Bad Debt Reserves

At the present time, commercial banks are subject to an industry-wide formula with respect to the accumulation of bad debt reserves. Each bank is permitted to make transfers to such reserves until the total equals 2.4 percent of eligible loans. Transfers in any single year are limited by certain provisions designed to prevent unduly rapid or large transfers. Eligible loans exclude loans insured or guaranteed by the Federal Government, such as FHA and VA loans, as well as certain other loans deemed by the Treasury to be virtually free of credit risk, such as Federal funds sold.

The present formula was adopted in 1965 after prolonged and intensive discussions between Treasury officials and representatives of the banking industry. Previously, banks could use what has been termed the individual experience method which, omitting a number of technical details, permitted each bank to increase its reserve up to a level equal to three times its annual loss experience averaged over any twenty-year period since 1927. For the banking industry as a whole, this individual experience method was equivalent to a ceiling of 2.4 percent, adopted in 1965 for all banks.

At present, treatment of bad-debt reserves is the result of long-standing regulation and considerable deliberation over the years, it can hardly be regarded as an omission or "loophole" in tax policy. Treatment of bad-debt reserves reflects broad public policy with respect to the structure and functioning of the commercial banking system.

For most of our nation's history, a fundamental objective of public policy has been that there should be a high degree of decentralization in our banking system. That is, the banking system should consist of a large

number of locally owned and controlled banks. The result is that today we have more than 13,000 commercial banks in the United States, and the great majority of these banks are small enterprises. Maintenance of the stability and solvency of this system has been a national problem of great and sometimes urgent consequence. I need not recount for this Committee the measures that have, over the years, been taken to assure that our nation will have a safe and sound banking system.

Moreover, public policy has treated commercial banking as having certain features and functions which set it apart from commercial enterprises in general. In other legislation before the Congress at the present time, we are, in fact, grappling with this very question of what constitutes commercial banking, related financial activities, and nonrelated commercial activities.

The present treatment of bad-debt reserves is one expression of the above basic public policies. Bad-debt reserves contribute to the solvency and stability of the banking system. The present formula recognizes that banks have a special need for bad-debt reserves and that satisfaction of this special need requires treatment that differs from that accorded commercial enterprises in general. Additionally, public policy has been increasingly directed to the objective of encouraging banks to make types of loans that are marginal or submarginal with respect to risk and net return, and which therefore require an even stronger bad-debt reserve position.

The argument for eliminating the present bad-debt reserve formula appears to rest upon a contention that the effective rate of taxation of commercial banks is low in comparison to non-financial businesses. The Report of the Committee on Ways and Means purports to show that the effective rate of Federal taxation of commercial banks in 1966 was only 23.2 percent. This percentage, however, significantly understates the incidence

of Federal taxation of banks.

The income taxes paid by commercial banks are not the sum total of what might, from the point of view of economic analysts, be regarded as Federal tax levies upon commercial banks. In 1968 insured banks paid $132.4 million to the Federal Deposit Insurance Corporation, and in addition, national banks paid $22. 7 million to the Office of the Comptroller of the Currency. These revenues were dedicated to the functions of bank examination and provision of deposit insurance, but though special in nature, they are, in effect, taxes.

More importantly, the Report of the Committee on Ways and Means included in the income base upon which the 23.2 percent was calculated the earnings received by banks from holdings of tax-exempt obligations of the states and political subdivisions. An analysis by the U. S. Treasury Department, which was submitted to this committee, shows that from 1962 through 1966 tax-exempt interest increased from 18.4 percent to 33.2 percent of the "economic income" of commercial banks, whereas the excess of bad-debt deductions over actual losses varied between 9.2 percent and 13.3 percent over this five-year period and stood at 10.7 percent in 1966.[1/] It is clear that the major reason for the apparently low incidence of Federal taxation of commercial banks is the existence of tax-exempt income from state and local government securities. Moreover, the decline in incidence in recent years is due almost entirely to expansion of holdings of tax-exempt securities, as banks have responded to meet the financial needs of state and local governments. To argue that bad-debt reserves should be reduced or eliminated because banks receive income from certain securities

1/ Tax Reform Studies and Proposals, U. S. Treasury Department, House Committee on Ways and Means and Senate Committee on Finance, February 5, 1969, Part 3, p. 475.

that are tax exempt is a non-sequitur.

We hold that the case for or against bad-debt reserves cannot be meaningfully argued on the basis of the incidence of Federal taxation of commercial banks vis-a-vis the incidence of non-financial corporations. The issue is whether special treatment of bad-debt reserves for commercial banks serves established public policy objectives at a reasonable cost to the Treasury. Another way of putting the issue is whether the present formula results in bad-debt reserves that are adequate in relation to the public policy objectives to be served.

Data collected in a special study of loan losses in the three years 1961 - 1963 show that in each of these years 213 banks, on the average, suffered loan losses equal to 2 percent or more of eligible loans.[2/] An average of 114 banks each year sustained losses equal to 3 percent or more of eligible loans. On the basis of this evidence we would expect to find that even in a period of reasonable stability in our economy, between 100 and 200 banks will each year suffer loan losses sufficient to wipe out or more than wipe out the maximum bad-debt reserve that can be accumulated under the present formula. Lacking the cushion provided by bad-debt reserves, a number of these banks could suffer such impairment of capital as to force liquidation or reorganization. The distress of bank failures in local communities, even without more far-reaching consequences, is too great to run the risk of a significant increase in the number of failures.

The provisions for a ten-year carry-back and five-year carry-forward of losses on loans, which would be substituted for the present formula, do not impress us as affording the same degree of protection as an established reserve. An established reserve for loan losses is immediately at hand. It

2/ Horvitz and Shapiro, "Loan Loss Reserves," National Banking Review, September 1964.

is something that the banker knows to be a part of his bank's structure of assets and liabilities and which he can take into account directly in the formulation of his lending policies. The carry-back, carry-forward allowance is something for which he must apply after he has sustained losses. Not being a part of the structure of assets and liabilities of the bank, the allowance is sufficiently remote that it is not likely to be given much weight in the formulation of loan policies.

Our essential point is that the concept of an established bad-debt reserve against outstanding loans should not be abandoned. The concept of a bad-debt reserve for mutual savings banks and savings and loan associations has been recognized in statute. The concept as applied to commercial banks has long standing but is the result of Treasury rulings rather than legislation. The Tax Reform bill would maintain the concept of bad-debt reserves for mutual savings banks and savings and loan associations. We believe and urge that the concept as applied to commercial banks should also be recognized and set forth in statute. That is, the ceiling and the base should be established by legislation.

In discussions with the Treasury over a number of years we have demonstrated that the present bad-debt reserve ceiling of 2.4 percent of eligible loans is not more than adequate. Our position continues to be that a lower ceiling would be less than adequate. We believe that the public interest is served by the maintenance of bad-debt reserves by commercial banks sufficient to meet sizable loan losses. We hope that the Congress will not reduce the emphasis that has been placed upon the objective of assuring that commercial banks have adequate capacity to incur credit risks and sustain loan losses. If, however, a change in emphasis must be made, we strongly recommend that it be effected within the framework of existing policy providing for an

33-758 O-69—No. 4—3

established reserve rather than being effected by abolishing for commercial banks the concept of bad-debt reserves.

In his proposals, the Secretary of the Treasury has recommended that commercial banks as well as mutual savings banks and savings and loan associations be permitted, under certain well defined conditions, to exclude from taxable income an amount equal to five percent of the income received from residential mortgages and other socially desirable loans. The Secretary's recommendation should be given thorough consideration. We have not had an opportunity to evaluate its full impact on banks of various sizes and various asset structures. However, we are firm in our belief that the Secretary's recommendation would not result in an effectual substitute for bad-debt reserves. We urge, as we have said, that the concept of the bad-debt reserve be maintained.

Concluding Comment on Securities Gains and Bad-Debt Reserves

The changes that would be effected by the Tax Reform bill with respect to gains on debt securities and bad-debt reserves have adverse implications for the stability and efficiency of the Government securities market and for the availability of bank credit. The close interrelationships between financial markets mean that these adverse effects will be felt, too, in such other areas as state and local government financing.

Is now the time to undertake structural changes that will adversely affect already stringent financing conditions? We think not. The provisions of the Tax Reform bill should be given much more thorough study. The need for such a study and the presently stringent conditions in the financial system argue strongly for more deliberate and extensive consideration than can be given this bill in the time remaining in this session of the Congress.

Sections 341 and 342 Relating to Accumulation Trusts

The American Bankers Association strongly opposes the enactment of Sections 341 and 342 of the Tax Reform bill of 1969 relating to accumulation trusts. There has been no evidence of tax avoidance which calls for the enactment of such a highly complex set of rules, which will be difficult to understand by taxpayers, difficult to apply by trustees, and difficult to enforce by the Internal Revenue Service. Enactment of such legislation will result in an unfair and burdensome application of harsh rules to trusts which were created for valid reasons entirely apart from tax considerations. Furthermore, the proposed legislation goes far beyond the indicated areas of potential abuse, which is primarily centered in the multiple trust area. Any capacity for abuse contained in the existing law can be adequately curtailed by existing enforcement procedures or by legislative enactments which would be substantially simpler and not so stringent and far-reaching as the present proposals.

The Tax-Avoidance Argument: The proposed legislation is apparently prompted by a concern that accumulation trusts may be used by a wealthy taxpayer as a device to minimize income taxes. Specifically, the fear is that such a taxpayer may reduce family income taxes by the creation of numerous trusts for the same beneficiary. However, no such tax abuse has ever been demonstrated. The Treasury report speaks only of a "capacity" for abuse, and indicates a concern that tax avoidance may result in the future by extensive use of multiple trusts.

It is the experience of corporate fiduciaries that accumulation trusts have not been the subject of tax exploitation. The vast majority of accumulation trusts administered by corporate fiduciaries have been established

because of the minority or other incapacity of the beneficiary or because the creator of the trust did not wish to place too much income in the hands of the beneficiary for personal reasons. The instances in which such trusts have been created for tax avoidance have been minimal. The experience with multiple trust arrangements is similar. For a variety of reasons, the multiple trust arrangement has rarely been used. The majority of taxpayers are reluctant to engage in tax gimmickry or to become associated with tax schemes which may require litigation to defend. In addition, the very complexity of fiduciary taxation and the vagueness of the law in the area of multiple trusts have created an effective barrier to the use of such arrangements. We submit that no past practice calls for the enactment of the complex type of legislation contained in the Tax Reform bill. Congress is being asked to legislate on the basis of a "potentiality" threat and a few fringe horror examples.

The Complexity of the Legislation: The principles of fiduciary income taxation are a highly intricate and complicated body of law. The "throwback rule" is particularly complex. The majority of the members of the bar, indeed even those specializing in taxation, are unfamiliar with trust taxation. The experience of many of our member banks is that the audit staff of the Internal Revenue Service is handicapped by a similar lack of knowledge. Needless to say, the taxpayer is completely unable to cope with legislation of this type and will invariably be put to the expense of highly specialized assistance.

The present law contains four exceptions which prevent the application of the throwback rule. These are: (1) accumulations during the minority of a beneficiary; (2) distributions for emergency needs; (3) distributions of $2,000 or less; and (4) final distributions made more than nine years

after the trust was created. Heretofore, these exceptions have spared many persons from being involved with this highly intricate statute. The elimination of the exceptions will inflict complexities upon many persons of modest means who will be completely unable to cope with them or who in many instances will be completely unaware of the obligation to pay the required tax. It will be virtually impossible for the Internal Revenue Service to establish an effective enforcement program to prevent the inadvertent avoidance of tax.

A situation which occurs rather frequently in trust practice will serve as an example to illustrate the formidable accounting and other problems inherent in the proposed legislation: The testator leaves the residue of his estate in trust for his two children, a son, A, and a daughter, B, who are respectively sixteen and fourteen years of age at his death. As in many cases, the testator provides that income is to be accumulated in each child's share until age twenty-one. Thereafter, income is to be paid to each child. The principal of his share is to be distributed to A at age fifty. The principal of B's share is to be distributed to her issue upon her death. In this fairly common situation, the trustee is required to create and maintain special records of the accumulations for use thirty-four years later in the case of A, and perhaps as much as sixty years later in the case of B. In B's case, his personal tax records must be preserved for thirty-four years. B's tax accountant will be called upon to determine whether the so-called "exact" or the "short-cut" method will be the most economical for his client. He therefore must be familiar with the tax law as it existed some thirty-four years before. The alternative will be to use the "short-cut" method under which the tax rate is determined by assuming that the average annual accumulation was received in the year of

distribution and the two prior years. Thus, tax rates determined by A's income when he was 48 to 50 years of age will be applied to determine the rate of taxation upon income earned when he was sixteen to twenty years of age. In B's case, income earned when she was fourteen to twenty years of age will be taxed to grandchildren at rates determined by the three-year period ending with the year of distribution to them -- perhaps sixty years later. No alternative method is possible since the beneficiaries were not in existence when the income was earned. It is submitted that consequences such as these represent taxation by chance and have little or no relation to the prevention of tax avoidance.

Although trust institutions would undoubtedly maintain the necessary records to account to beneficiaries for accumulations made over a period of years, it is certain that many individual trustees will not do so. Thus, many beneficiaries, particularly those in modest circumstances, will be subjected to great difficulties in preparing tax returns for years in which trust distributions are received.

Problem May Be Solved By Other Means: The potential tax avoidance which Sections 341 and 342 seek to prevent primarily springs from the multiple trust arrangement in which a series of trusts is created for the benefit of a single beneficiary. The proposed legislation, however, goes far beyond this and is applicable to a single "spray" or a single accumulation trust. In effect, it would destroy the long-standing principle that a trust may be an independent tax entity. The elimination of the trust as a separate tax entity, not the elimination of multiple trust arrangements, accounts for the $70 million revenue gain which the Treasury estimates will be generated by the proposal. The problem of tax avoidance through the use of multiple trusts can be solved by means far less drastic than the present

intricate and hard-to-understand proposal. The courts have sufficient authority to prevent abuse in this area. The Treasury concedes in its Tax Reform Studies (P. 167) that multiple trust "devices are of doubtful validity under present law." It has been successful in striking down multiple trust arrangements in recent cases. E. P. Boyce, 190 F Supp. 950, aff'd per curiam, 296 F. 2d 731 (5th Cir 1962); R. R. Sence, 68-1 U.S.T.C. #9368 (Ct. Cl. 1968). If the Treasury cannot curb the creation of tax-motivated multiple trusts by an effective enforcement program in the courts, its position may be adequately buttressed by simple legislation containing language similar to that in present Code Section 269 under which multiple trusts would be declared invalid if the principal purpose for their creation is the avoidance of tax. The problem of multiple trusts may also be more simply solved by legislation which would apply the unlimited throwback rule only when more than one trust is created by the same donor for the same beneficiary; the unlimited throwback rule would be applied only to the second and any subsequent trusts.

It is submitted also that the exceptions to the throwback rule contained in the present law should be preserved. Their combined effect is to spare taxpayers from the application of the rule when the reason for the income accumulation is other than tax avoidance. Several of the exceptions on their face are a direct refutation of the tax abuse argument. For example:

1) Little if any tax avoidance can exist with respect to accumulations during the minority of a beneficiary. In most cases, the beneficiary's tax bracket is as low or lower than that of the trustee.

2) No tax avoidance is likely in the case of emergency distributions. If a beneficiary is in the midst of a financial emergency, he is not likely

to be a high income tax bracket taxpayer.

3) The exception for de minimus distributions of $2,000 or less leaves little room for tax avoidance. The Treasury's Reform Studies (p. 166) assume an unlikely example of a single taxpayer in a high tax bracket. The example involves a fringe situation which is seldom encountered in actual practice.

Effective Date: It is unfair to apply any legislation modifying the throwback rules retroactively. Trustors have made irrevocable commitments on the basis of the law as it applied to them. Although in discretionary trusts, the trustees may distribute income by the exercise of their discretion (assuming that the circumstances of the beneficiaries are such as to permit such exercise under the terms of the instrument), in many cases the income is required to be accumulated by the terms of the governing instrument. Any modifications of the law should therefore be applied only to trusts created after the effective date of the statute, not to distributions made after the effective date.

Section 201 Relating to "Split-Interest" Trusts

The American Bankers Association urges against the enactment of Section 201 of the Tax Reform bill insofar as it requires the establishment of an annuity trust or a unitrust for the allowance of income tax, estate tax or gift tax deductions for "split-interest" gifts to charity.

Despite the fact that some trustees of "split-interest" trusts may have invested trust assets in a manner which favors noncharitable beneficiaries, the problem in this respect has not been so great as to require the extreme approach adopted in the proposed statute. The requirements of

the statutory proposal will significantly discourage charitable gifts, particularly gifts of charitable remainders in trust. The new rules are appreciably more complicated than the old, and will not be readily understood by potential donors. In addition, it will be necessary for many testators and trustors to redo wills and trust agreements to conform to the new requirements. The result will be a curtailment of gifts to charity.

The requirement that an annuity trust or unitrust be established is designed to prevent the manipulation of trust investments in favor of noncharitable beneficiaries. However, we believe that any such manipulation has been a fringe problem and not substantial in amount. Most "split-interest" trusts have been created primarily to obtain the advantages of a deferred gift to charity or to reduce the value of a taxable remainder by the creation of an intervening income gift to charity. In short, the primary motivation for the form of the gift has been the tax advantage generated by the combination of the two gifts, not the possibility of advantage derived from investment manipulation. In addition, local law requires that fiduciaries fairly balance the interests of the income beneficiaries and the remaindermen. This overriding fiduciary duty of impartiality to all beneficiaries if sufficient assurance that the vast bulk of such trusts will be properly administered. New and complex legislation should not be enacted in an attempt to penalize fringe violations of established legal principles when in fact the punishment will be inflicted primarily upon the innocent charitable donees.

The proposal would reduce the investment flexibility of trusts having both charitable and noncharitable beneficiaries. The requirement that a predetermined dollar amount be paid annually to the current beneficiary, regardless of the income earned by the trust assets, may compel sales of

assets at undesirable prices -- and possibly at distress prices -- when the assets are difficult to sell or are not readily marketable. It is likely that trustees will be prompted to maintain investments in high income assets, thereby increasing the investment risk, or alternatively, to maintain a portion of the trust in highly liquid, short-term funds. Statutory tax considerations should influence the form of trust investments only when there is a demonstrated case of significant tax abuse.

The proposed statute would inflict further burdens and expense upon the administration of trusts. It will require additional tax expertise, more frequent investment activity, and yearly valuations of trust assets, which may be an expensive and formidable task when closely-held stock or real estate is involved. The valuation of such assets may involve the trustee in frequent disputes with the Internal Revenue Service.

Section 515 Relating to Distributions From Employee Benefit Trusts

We also oppose the enactment of Section 515 of the Tax Reform bill under which lump sum distributions from qualified employee benefit trusts would be taxed as ordinary income, and the tax computed in accordance with a complicated averaging device. The capital gains treatment given to such distributions under present law is founded upon the theory that it is unfair to "bunch" all of the income received in such a lump sum distribution and to tax in one year at ordinary income tax rates income which normally accrues over a period of many years. Capital gain treatment is both simple and fair. The five-year forward averaging device adopted by Section 515 only partially reduces the unfairness of the bunching, since in most cases

the income has accrued over an appreciably longer period of time. Section 515 would add substantial complexities to the law and is administratively cumbersome insofar as it permits a recalculation of the tax five years after receipt of the distribution under the so-called "look-back" rule. In the vast majority of cases, the disparity in tax rates between capital gains treatment and the ordinary income treatment adopted in Section 515 is not so great as to warrant the intricate approach adopted.

It is important that an individual be permitted to make adequate provision for his spouse and children at death. Pension and profit-sharing plans are an important source of family security at death and their growth should be encouraged by the tax laws. The primary impact of an increase in the rate of taxation will be upon a decedent's survivors, and the increase will be applicable to modest payments as well as to large ones. For these reasons we oppose the enactment of Section 515.

Withholding of Interest and Dividends

The proposed amendment by Senator Kennedy to H. R. 13270 (Amendment No. 140) would require payers of interest and dividends to withhold from the owners of such interest and dividends 20% on account of income taxes, even though experience shows that a large number of such owners would not be required to pay income taxes.

The American Bankers Association strongly objects to this proposal which would place an onerous burden of work and expense upon banking institutions and other payers of interest and dividends, such as mutual savings banks, savings and loan associations, insurance companies and other corporations. A great deal of study was given to this subject by The

American Bankers Association and many conferences were held with officials and staffs of the Treasury Department and the IRS to discuss the difficulties and problems that would be encountered when a similar proposal was advanced during the consideration by the Congress of the Revenue Act of 1962. The Senate rejected the proposal at that time, as it did on previous occasions in 1942, 1950, and 1951.

Senator Kennedy states that the IRS estimates that $4 billion of interest and dividends is not reported by American taxpayers, and that $1 billion in taxes is payable on such income. This is the same as an estimate made by the Treasury Department in 1959 based upon interest payments in 1957. The introduction of the system of information returns in 1962 must have accounted for an increase in the amount of interest income reported on tax returns, even though the amount of interest and dividends paid has increased substantially since that time.

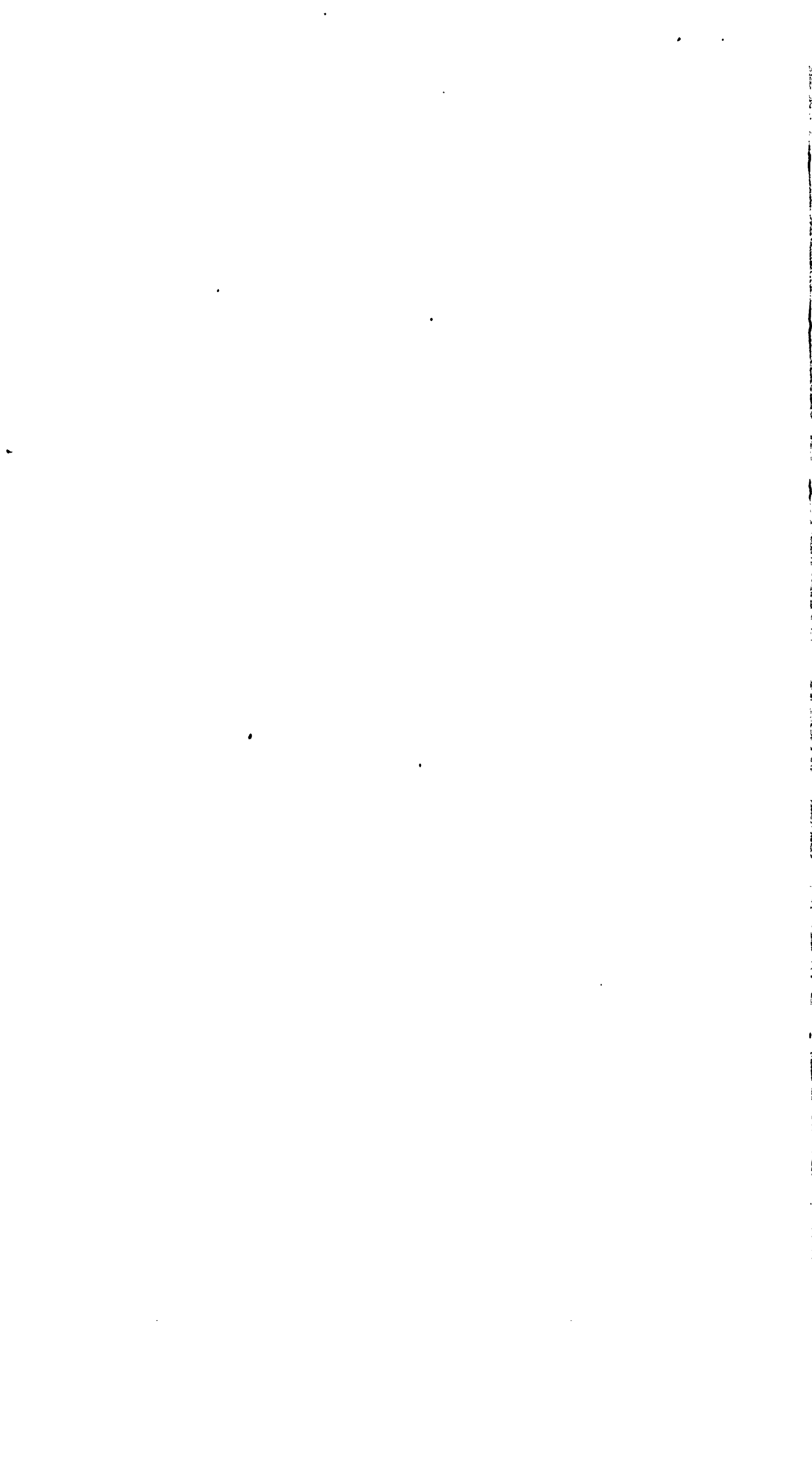
Under the Revenue Act of 1962 banks and other payers of interest and dividends, at great expense to themselves, have annually filed millions of information returns on Form 1099 with the IRS reporting amounts of interest and dividends paid to their customers. To the best of our knowledge and belief only a relatively small percentage of those returns have been used by the IRS to determine whether the amounts reported on Form 1099 have in fact been included in taxpayer returns. Thus, the IRS has for a number of years had the means at its disposal to ascertain the taxpayers who have not reported or paid taxes on such income.

We understood that when banks and other payers of interest and dividends were required under the Revenue Act of 1962 to file information returns with the IRS that those returns would be used to verify the proper reporting of interest and dividends in taxpayer returns.

It is suggested that before the Committee considers the withholding proposal the IRS be required to furnish the Committee information showing the number of Form 1099's received each year under the Revenue Act of 1962, the number of such forms used by the IRS in verifying taxpayer returns, and the amount of unreported income discovered by the use of such information returns. An explanation of the basis of the estimate of $4 billion in unreported interest income should also be furnished. Until the IRS exhausts the information at its disposal to check taxpayer returns, we do not believe there is any valid basis for requiring private industry at great expense to undertake to withhold taxes of this character from their customers.

Senator Kennedy's amendment which merely provides the statutory basis for withholding interest and dividends requires six pages of the Congressional Record to spell out such provisions. It leaves the details of the withholding procedures to be carried out by the IRS in its regulations. The withholding requirements, including the use of exemption certificates, the treatment of interest payments on securities sold or transferred between interest payment dates, are most complex. In addition, a serious problem will be encountered in explaining the new requirements to millions of customers.

It is apparent, therefore, that implementation of any such provision would be a massive undertaking for the Government and for payers of interest and dividends. Accordingly, an effective date of January 1, 1970, if legislative action were to be taken, would be completely unrealistic.



SUMMARY

Statement of Charles H. Ogilvie, Chairman

The National Association of Business Development Corporations

Before the Senate Finance Committee, September 15, 1969

1. Business development corporations are organized specifically and solely to make non-bankable loans to small companies for the purpose of strengthening them and creating jobs resulting in furtherance of sound economic development.

2. Development corporations are dissimilar to commercial banks, savings and loan associations, and mutual savings banks in source of funds, services offered, and types of loans made. No loan can be made by them unless it is substandard by conventional lending criteria.

3. The uniqueness of the corporations and the risks inherent in their types of loans justify their separation from all other types of lenders under the tax reform bill and a more liberal treatment in establishment of reserves for loan losses.

STATEMENT OF CHARLES H. OGILVIE, CHAIRMAN,

THE NATIONAL ASSOCIATION OF BUSINESS DEVELOPMENT CORPORATIONS

BEFORE THE SENATE FINANCE COMMITTEE, SEPTEMBER 15, 1969

Business development corporations are organized under specific acts of state legislatures for the purpose of promoting, stimulating, developing, and advancing business prosperity and economic welfare of the individual states and their citizens; to strengthen and assist through loans, investments and other business transactions all kinds of business activity in order to promote economic development and provide maximum opportunities for employment. This goal is met by making investments in and loans to businesses which have been denied credit by conventional lenders such as commercial banks, savings and loan associations, and insurance companies. The denial of credit by conventional lenders is usually a statutory requirement and a necessary condition to a loan by a business development corporation.

Although altruistic in nature, business development corporations are organized as profit making companies. Almost without exception stock has been subscribed by conventional lending institutions, public utility companies, and public-spirited citizens through a sense of civic responsibility in order to make available a source of loans which otherwise would be denied those small companies in a weak financial condition but possessing potential, having insufficient collateral with which to secure a conventional loan, or having need of low debt service possible only through long term financing.

33-758 O-69—No. 4—4

The corporations have no depositors, handle no checking accounts, perform no trust functions, nor provide any service normally associated with conventional lending institutions. To reiterate, even the loans made by the corporations must be adjudged unbankable.

As their source of funds the companies utilize lines of credit established with banks, savings and loan associations, and insurance companies. The credit lines are proportioned to the size and type of these institutions and can be unilaterally withdrawn by them at any time with proper notice. Loans to development corporations are uncollateralized, secured only by their notes. Most corporations are highly leveraged, being able, generally, to borrow amounts varying from ten to twenty times paid-in capital.

There are presently twenty eight business development corporations in operation with experience ranging from several months to twenty years. Enabling legislation has been passed in several other states with organization of the corporations yet to be completed. Enabling legislation is necessary to effective operation of the corporations because the loans to them by conventional lenders would otherwise be classified substandard by state and national supervisory authorities. This fact lends emphasis to the risk generally acknowledged by authorities to exist in all loans by the corporations.

The corporations have been operating in a generally favorable business environment but, even so, some have sustained losses ranging up to five and six percent of loans outstanding and one has failed. Higher losses can be expected in a recessional period due to

loan portfolios being comprised entirely of unbankable loans supported by substandard collateral. Loans by the corporations vary from low five figures to high six figures with the average in the low six figure range. The typical portfolio contains from twenty to forty loans. Thus development corporations are not afforded the spread of risk enjoyed by most conventional lenders. With terms of ten to twenty years business development corporation loans are in a class by themselves, sensitive even to modest deteriorations in business activity. It should be recognized that the concentration of risk and large amounts involved are indicative of total losses exceptionally high in terms of loans outstanding and paid-in capital.

The management of every corporation has recognized the necessity of building appropriate loan loss reserves; however, no uniform method of allocation exists largely because of variations in treatment by Internal Revenue Service agents in different sections of the country. Present reserve levels vary from one to four percent of loans outstanding due to these variations in treatment. So far as we are aware, we are the only financial institution that has not had a special bad debt reserve recognized by the Internal Revenue Service and created either by statute or regulation. Thus commercial banks have been permitted a reserve of 2.4%, savings and loans and mutual savings banks have a 6% reserve and small business investment companies have been allowed a 10% reserve. Under the House bill, and we presume under the Administration's proposal, all these institutions would be permitted to keep their present reserves up to those limits. No such provision is made for reserves of business development corporations. However, we believe that we are, among all these

institutions, the lenders with the least prospect for profit and probably the greatest potential of risk. Furthermore, although technically organized as profit-making organizations, we are actually quasi-public instrumentalities performing, in the words of Secretary Kennedy, "socially preferred functions".

It has been suggested that reserves be established on the basis of loss experience. Due to the precipitate manner in which loans would go bad and due to their size, a corporation would be out of business before the experience could inure to its benefit. In other words, when trouble strikes, it strikes fast and it strikes big. At the same time it is obvious that a 2.4% loss reserve maximum is inadequate. Moreover, the ten-year carryback and five-year carry-forward provisions will not provide an adequate cushion because of the modest profits, if any, generated by the typical corporation. On the average two and one half years of corporate earnings are insufficient to offset the loss of one loan.

Although loss experience, with some notable exceptions, has generally been good to date, two or three losses in any of the corporations could be substantial enough to impair capital. Impairment of capital of our highly leveraged corporations would have a severe psychological impact on the financial institution lenders which provide us money. This impact would manifest itself in their withdrawing presently available lines of credit so that our corporations would be rendered ineffective at a time when additional funds would be needed to help our borrowers through difficult economic conditions.

Under H.R. 13270, Sub-Title E, Section 585, business development corporations have been treated on a par with commercial banks in all respects, including rules for addition to reserve for bad debts.

Our National Association feels strongly that business development corporations should be placed in a separate category due to the difference in purpose, the difference in types of loans made, and the greater risks involved in making these loans.

In its bill the House has recognized that reserves for losses should bear a relation to the purpose and nature of the institution concerned. We have a socially recognizable purpose of the highest order in that we create jobs and strengthen the financial position of small companies.

We respectfully submit that business development corporations should be allowed to retain presently established bad debt reserves built from earnings of the corporation, provided that the reserve does not exceed 10% of outstanding loans at year end. Excluded from "loans" are any parts guaranteed by an agency of the Federal government and any parts belonging to others through a participation arrangement. As to the future, business development corporations should be allowed a tax-free allocation to the reserve for losses equal to the greater of the following: 60% of pre-tax income, reducing at the rate of 2% per year over a 10-year period to a minimum of 40% of taxable income, or loss experience based on the current year and the preceding five years. New business development corporations, in the first year of operation, would commence building reserves with 60% of taxable income, reducing to 40%, as above. In no case would

the reserve of any business development corporation be allowed to exceed 10% as mentioned above.

Alternatively, the committee may wish to adopt a provision relating the bad debt reserve deduction directly to the total loans outstanding at year end. In this case, we would recommend that business development corporations be permitted to deduct from taxable income such amount as would be required to maintain a bad debt reserve in the amount of 10% of outstanding loans at year end.

The staff of the Joint Committee on Internal Revenue Taxation has made a study of our industry and our case for special bad debt treatment. I feel certain that Dr. Laurence N. Woodworth, who heads the committee staff, would furnish you with the results of that study.

To be effective in our sphere of endeavor, which is unoccupied by any other type of institution or corporation, we respectfully request the Committee's favorable consideration of the suggestions herein set forth and formalized in the attached proposed amendment to H.R. 13270.

NASBIC

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

537 WASHINGTON BUILDING • TELEPHONE (202) 638-3411

WASHINGTON, D. C. 20005

EXECUTIVE DIRECTOR
WALTER B. STULTS
ASST. EXEC. DIRECTOR
ALLEN NEECE, JR.
GENERAL COUNSEL
CHARLES M. NOONE

OFFICERS

PRESIDENT
• GEORGE C. WILLIAMS
ALLIED CAPITAL CORP
WASHINGTON

FIRST VICE PRESIDENT
• THOMAS M. CROSBY
NORTHWEST GROWTH FUND, INC
MINNEAPOLIS

SECOND VICE PRESIDENT
• B. D. CLARK
CITIZENS & SOUTHERN
CAPITAL CORP
ATLANTA

SECRETARY
• TIMOTHY MAY
FIRST SBIC OF CALIFORNIA
LOS ANGELES

TREASURER
• DAVID ENGELSON
FIRST CONNECTICUT SBIC
BRIDGEPORT

BOARD OF GOVERNORS

THE OFFICERS AND

LOUIS L. ALLEN
CHASE MANHATTAN CAPITAL CORP
NEW YORK

J. R. ARNOLD
SMALL BUSINESS ASSISTANCE CORP
PANAMA CITY BEACH, FLA

SOLOMON BERENSON
CAPITAL INVESTMENT COMPANY
OF WASHINGTON D C

DONALD E. BLEAKLEY
SMALL BUSINESS FUNDS, INC
CLEARWATER FLA

• ALAN BRADLEY
CAPITAL INVESTORS CORP
OF MONTANA
MISSOULA

ALLEN F. CALDWELL, JR.
CSRA CAPITAL CORP
AUGUSTA GA

FRANK G. CHAMBERS
CONTINENTAL CAPITAL CORP
SAN FRANCISCO

DON A. CHRISTENSEN
GREATER WASHINGTON
INDUSTRIAL INVESTMENTS INC
WASHINGTON

BLAINE E. D'ARCEY
CENTRAL INVESTMENT CORP
OF DENVER

ROBERT DAVIDOFF
CUNY CAPITAL CO., INC
NEW YORK

• ELLIOTT DAVIS
ALLIANCE BUSINESS INVESTMENT CO
TULSA

• DANIEL J. DONAHUE
LASALLE STREET CAPITAL CORP
CHICAGO

RICHARD A. FARRELL
FIRST SBIC OF NEW ENGLAND
BOSTON

• BERNARD C. HECHT
BRUNSWICK CAPITAL CORP
HILLSIDE, N. J.

WILLIAM E. LADIN
SBIC OF HOUSTON

EUGENE W. LANDY
MONMOUTH CAPITAL CORP
TOMS RIVER, N. J.

R. R. LYON
LYON CAPITAL CORP
PALO ALTO, CAL

ROBERT F. PALMER
CAPITAL CITY EQUITY COMPANY
SANTA ANA, CAL

ALAN K. RUVELSON
FIRST MIDWEST CAPITAL CORP
MINNEAPOLIS

F. W. SIMMONS
SAN FRANCISCO-PACIFIC FUND, INC
PORTLAND, ORE

LEON A. SPIELMAN
ADELPHIA CAPITAL INVESTMENT CORP
PHILADELPHIA

I. JACK STEPHENS
CAPITAL, INC
OKLAHOMA CITY

MELVIN STRUTHERS
IOWA GROWTH INVESTMENT CO
CEDAR RAPIDS

• EXECUTIVE COMMITTEE

STATEMENT OF GEORGE C. WILLIAMS, PRESIDENT
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
BEFORE THE
FINANCE COMMITTEE, UNITED STATES SENATE
September 15, 1969

<u>Principal Points</u>

1. Section 421, proposing the taxation of "disproportionate distributions",would unduly complicate SBIC financing arrangements and adversely affect shareholders of small business concerns financed by SBICs. It is recommended that SBIC financing transactions be exempted from the proposals relating to the taxation of "disproportionate distributions".

2. Section 443, intended to establish "parallel treatment" for similarly situated financial institutions, would treat gains on the sale of securities as ordinary income. The section neglects however to establish corresponding parallel treatment under Code Section 582(a) by granting SBICs ordinary loss treatment on securities such as that now extended to banks. We recommend this be done.

3. The Treasury proposal to allow a deduction of 5% of gross interest income from certain loans should be broadened to permit the same deduction to SBICs on loans guaranteed by SBA and to make certain that any SBA-guaranteed loan to an SBIC will likewise qualify for the proposed deduction.

NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

537 WASHINGTON BUILDING • TELEPHONE (202) 638-3411
WASHINGTON, D. C. 20005

EXECUTIVE DIRECTOR
WALTER B. STULTS
ASST. EXEC. DIRECTOR
ALLEN NEECE, JR.
GENERAL COUNSEL
CHARLES M. NOONE

OFFICERS
PRESIDENT
• GEORGE C. WILLIAMS
ALLIED CAPITAL CORP
WASHINGTON
FIRST VICE PRESIDENT
• THOMAS M. CROSBY
NORTHWEST GROWTH FUND, INC
MINNEAPOLIS
SECOND VICE PRESIDENT
• B. D. CLARK
CITIZENS & SOUTHERN CAPITAL CORP
ATLANTA
SECRETARY
• TIMOTHY HAY
FIRST SBIC OF CALIFORNIA
LOS ANGELES
TREASURER
• DAVID ENGELSON
FIRST CONNECTICUT SBIC
BRIDGEPORT
BOARD OF GOVERNORS
THE OFFICERS AND
LOUIS L. ALLEN
CHASE MANHATTAN CAPITAL CORP
NEW YORK
J. R. ARNOLD
SMALL BUSINESS ASSISTANCE CORP
PANAMA CITY BEACH FLA
SOLOMON BERENSON
CAPITAL INVESTMENT COMPANY
OF WASHINGTON D C
DONALD E. BLEAKLEY
SMALL BUSINESS FUNDS, INC
CLEARWATER FLA
• ALAN BRADLEY
CAPITAL INVESTORS CORP
OF MONTANA
MISSOULA
ALLEN F. CALDWELL, JR
CSRA CAPITAL CORP
AUGUSTA, GA
FRANK G. CHAMBERS
CONTINENTAL CAPITAL CORP
SAN FRANCISCO
DON A. CHRISTENSEN
GREATER WASHINGTON
INDUSTRIAL INVESTMENTS INC
WASHINGTON
BLAINE E. D'ARCEY
CENTRAL INVESTMENT CORP
OF DENVER
ROBERT DAVIDOFF
CUNY CAPITAL CO., INC
NEW YORK
• ELLIOTT DAVIS
ALLIANCE BUSINESS INVESTMENT CO
TULSA
• DANIEL J. DONAHUE
LASALLE STREET CAPITAL CORP
CHICAGO
RICHARD A. FARRELL
FIRST SBIC OF NEW ENGLAND
BOSTON
• BERNARD C. HECHT
BRUNSWICK CAPITAL CORP
HILLSIDE N J
WILLIAM E. LADIN
SBIC OF HOUSTON
EUGENE W. LANDY
MONMOUTH CAPITAL CORP
TOMS RIVER, N J
R. R. LYON
LYON CAPITAL CORP
PALO ALTO, CAL
ROBERT F. PALMER
CAPITAL CITY EQUITY COMPANY
SANTA ANA CAL
ALAN K. RUVELSON
FIRST MIDWEST CAPITAL CORP
MINNEAPOLIS
F. W. SIMMONS
SAN FRANCISCO PACIFIC FUND, INC
PORTLAND, ORE
LEON A. SPIELMAN
ADELPHIA CAPITAL INVESTMENT CORP
PHILADELPHIA
I. JACK STEPHENS
CAPITAL, INC
OKLAHOMA CITY
MELVIN STRUTHERS
IOWA GROWTH INVESTMENT CO
CEDAR RAPIDS
• EXECUTIVE COMMITTEE

STATEMENT OF GEORGE C. WILLIAMS, PRESIDENT
NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES
BEFORE THE
FINANCE COMMITTEE, UNITED STATES SENATE
September 15, 1969

Gentlemen:

My name is George C. Williams. I am President of the National Association of Small Business Investment Companies ("NASBIC"). Our Association represents 225 of the 350 active companies licensed by the Small Business Administration under the Small Business Investment Act of 1958 ("1958"). The member companies of our Association account for over 80% of the assets committed to the SBIC program.

In the ten years since the passage of the 1958 Act, SBICs have made over $1.5 billion available to small business concerns in over 30,000 separate financings. At the present time, the active SBICs have total assets of about $585 million and have disbursed an average of $150 million a year over the past two years to small business concerns.

We are particularly concerned with Sections 421 and 443 of H.R. 13270 as they would affect the financing activities of SBICs.

Section 421 of the bill, relating to stock dividends, would, as we understand it, result in taxable income to shareholders of small business concerns financed by SBICs where there are "disproportionate distributions" by such portfolio companies. I refer specifically to the proposed treatment of convertible preferred stock and changes in conversion ratios and redemption prices.

We have no quarrel with the present law taxing distributions of property where the shareholders can elect between a stock dividend and the receipt of cash or other property, but we are fearful that the proposed extension of this principle to convertible securities could produce harmful results for shareholders of our portfolio companies and add considerable complexity to SBIC financing arrangements.

SBICs are venture capital companies. They are encouraged to provide long-term loan funds and equity capital to eligible small business concerns. The 1967 Amendments to the Small Business Investment Act of 1958 encouraged SBICs to increase their equity-type financing as distinguished from straight lending.

While definitive statistics on the nature of SBIC financings that would be adversely affected by the pending proposals are not available, we estimate that a substantial and significant number of them do include convertible preferred stock or other convertible securities, including warrants or options, in which provisions are made for changes in conversion ratios and redemption prices geared to the holding period on such securities and changes in the earnings or net worth of portfolio companies.

We are particularly concerned that the bill would vest in the Secretary of the Treasury or his delegate the authority to determine what types of transactions might be treated as disproportionate distributions. We can see this suggestion leading to considerable confusion and endless litigation.

We urge this Committee to amend Section 421 of the bill to exempt SBIC financing instruments from the provisions of that section relating to disproportionate distributions. In the alternative, and in lieu of delegating decisions in this important area to the Treasury Department, we urge the Committee to write into the bill precise language on which we and our portfolio concerns can rely in providing needed venture capital financing to small business concerns. We further urge that any change of this nature be made effective only with respect to future financing transactions, and that it not apply to outstanding instruments.

Section 443 of the bill would treat gains on securities held by financial institutions as ordinary income. As the reports of the Committee on Ways and Means point out, this particular provision is designed to accomplish parallel treatment for similar types of financial institutions. But the bill would amend only subsection (c) of Section 582 of the Code and Section 1243 relating to SBICs. If parallel treatment is indeed to be accomplished, we likewise recommend amendment of subsection (a) of Section 582.

Subsection 582(a) of the Code now permits a "bank" to take an ordinary loss on a debt which is evidenced by a security as defined in Code Section 165 (g)(2)(C). Contrary to the assertion contained in the House Committee report relating to this section, SBICs are not now given similar treatment. We believe they should be given parallel treatment under this section as well as under subsection 582(c).

We would suggest therefore that subsection 582(a) of the Code be further amended by striking the word "bank" and by substituting the language now proposed to be included in subsection 582(c), namely "financial institution to which Section 585 or 593 applies..." Such an amendment would conform to the proposed amendment relating to the heading for Section 582 which would substitute the words "financial institutions" for the word "banks".

We were pleased to note the recommendations of Secretary Kennedy and Assistant Secretary Cohen of the Treasury Department in their September 4 statements before this Committee where they proposed a special tax deduction of 5% of gross interest income from loans for residential construction and "loans guaranteed by the Small Business Administration". We were concerned, however, that Secretary Kennedy particularly seemed to suggest the deduction only for commercial banks, mutual savings banks and savings and loan associations.

Due to recent budgetary restrictions, the Small Business Administration has been unable to provide any direct financing to SBICs. As an alternative, the Agency and the SBIC industry have

been seeking money needed to continue their financing activities not only from banks but from insurance companies, pension funds and other institutional lenders, these loans to be backed by SBA guarantees. We would hope therefore that the proposed interest deduction on SBA-guaranteed loans, if adopted by the Committee, would be available to any lending institution providing funds to SBICs on loans guaranteed by SBA.

By the same token, SBA has been actively exploring the possibility of guaranteeing SBIC loans in certain areas. We would hope therefore that should such a guarantee program be inaugurated, SBICs likewise would qualify for the special tax deduction proposed by the Treasury Department.

I am advised that the National Small Business Association has informed your Committee by letter of its support of our statement with respect to Section 421 of the bill. It is respectfully requested that the letter from the National Small Business Association be incorporated in the record of this proceeding at this point.

We thank you for this opportunity to appear.

STIMULATION, LIKE PUMP PRIMING, IS REQUIRED ONLY UNTIL THE FLOW STARTS AND THEN SHOULD BE DISCONTINUED. WE HOPE THAT IN THE FUTURE PUMP-PRIMING SUBSIDY TAX LEGISLATION WILL HAVE AN EXPIRATION DATE SUITABLE TO ITS PURPOSE.

THE PRINCIPAL PROVISION APPLYING TO COMMERCIAL BANKS

THE PRINCIPAL PROVISION APPLYING TO COMMERCIAL BANKS IN THE HOUSE BILL (H.R. 13270), IF ENACTED, WOULD RESULT IN THE COLLECTION OF ADDITIONAL TAXES FROM COMMERCIAL BANKS OF APPROXIMATELY $250 MILLION ANNUALLY. IT PROVIDES FOR THE ELIMINATION OF THE 2.4-PERCENT BAD-DEBT LOSS RESERVE AND PLACES THE BANKS ON AN ACTUAL EXPERIENCE BASIS.

MANY BANKERS WILL FEEL THAT UNLESS THE SAVINGS AND LOAN ASSOCIATIONS AND MUTUAL SAVINGS BANKS ARE TAXED IN THE SAME WAY ON THEIR EARNINGS AS COMMERCIAL BANKS ARE, TAX EQUALITY WILL NOT HAVE BEEN ACHIEVED AND AN UNFAIR LOOPHOLE WILL STILL EXIST.

THE HOUSE BILL WOULD IN THE FUTURE BASE THE BAD-DEBT RESERVES OF COMMERCIAL BANKS ON ACTUAL LOSS EXPERIENCE. IT WOULD REDUCE, OVER A 10-YEAR PERIOD, THE SPECIAL BAD-DEBT ALLOWANCES NOW ALLOWED TO SAVINGS AND LOAN ASSOCIATIONS AND MUTUAL SAVINGS BANKS; IT WOULD NOT ELIMINATE THEM. THUS, THE HOUSE BILL PROVIDES AN IMPERFECT SOLUTION AS FAR AS THE COMMERCIAL BANKS ARE CONCERNED.

ACCORDING TO THE WAYS AND MEANS COMMITTEE, THE HOUSE BILL WOULD RESULT IN COMMERCIAL BANKS PAYING AN EFFECTIVE TAX RATE OF ABOUT 31 PERCENT. THE REASON THIS RATE IS COMPUTED TO BE LESS

THAN THE FULL EFFECTIVE TAX RATE OF ABOUT 44 PERCENT PAID BY INDUSTRIAL CORPORATIONS IS BECAUSE OF THE WAY IN WHICH INCOME RECEIVED FROM TAX-EXEMPT MUNICIPAL OBLIGATIONS IS HANDLED IN THE COMPUTATION. THE WAYS AND MEANS COMMITTEE ADDS THE FULL AMOUNT OF TAX THEREON. IN REAL ECONOMIC TERMS, THIS APPROACH IS NOT CORRECT.

TAX-EXEMPT INTEREST AND THE EFFECTIVE TAX RATE

SINCE THE MUNICIPALITY PAYS SUBSTANTIALLY LOWER INTEREST THAN WOULD BE PAID ON A TAXABLE BOND, THE TRANSACTION IS THE SAME FROM AN ECONOMIC STANDPOINT AS THOUGH THE MUNICIPALITY HAD SOLD THE BOND AT THE GOING INTEREST RATE FOR COMPARABLE TAXABLE BONDS, THE HOLDER OF THE BOND HAD PAID A TAX EQUAL TO THE DIFFERENCE BETWEEN THE GOING INTEREST RATE AND THE LOWER RATE ACTUALLY PAID BY THE MUNICIPALITY, AND THIS TAX HAD BEEN TURNED OVER TO THE MUNICIPALITY.

CONSEQUENTLY, TO CORRECTLY COMPUTE THE EFFECTIVE TAX RATE OF BANKS HOLDING TAX-EXEMPT BONDS, IT IS NECESSARY TO ADD TO TAXABLE INCOME THE AMOUNT THE BANK WOULD HAVE RECEIVED HAD IT PURCHASED TAXABLE BONDS AND TO ADD TO THE TAX PAID BY THE BANKS THE BENEFIT REALIZED BY THE MUNICIPALITY FROM THE TAX SUBSIDY.

ON THIS BASIS, UNDER THE HOUSE BILL, COMMERCIAL BANKS WOULD PAY AN EFFECTIVE TAX RATE ON THEIR ECONOMIC INCOME THAT WOULD BE GENERALLY COMPARABLE TO THE EFFECTIVE RATE PAID BY INDUSTRIAL CORPORATIONS.

33-758 O-69—No. 4—5

THE HOUSE BILL DOES NOT EQUALIZE BAD-DEBT LOSS RESERVES

WE WERE DISAPPOINTED THAT THE HOUSE BILL DID NOT EQUALIZE THE BAD-DEBT LOSS RESERVES FOR THE BANKS ON THE ONE HAND AND THE SAVINGS AND LOAN ASSOCIATIONS AND THE MUTUAL SAVINGS BANKS ON THE OTHER, ALTHOUGH ITS PROPOSALS, WITH SOME MODIFICATIONS, WOULD REPRESENT IMPROVEMENT OVER PRESENT TAX FORMULAE.

TREASURY RECOMMENDATIONS

THE TREASURY RECOMMENDATIONS RELATING TO FINANCIAL INSTITUTIONS DIFFER FROM THE HOUSE BILL. FIRST, THEY WOULD BASE FUTURE ADDITIONS TO BAD-DEBT RESERVES OF ALL FINANCIAL INSTITUTIONS ON ACTUAL LOSS EXPERIENCE. THIS WOULD ACHIEVE THE FULL EQUALITY OF TAX TREATMENT THAT OUR ASSOCIATION HAS SO LONG SUPPORTED. THEN, THE TREASURY RECOMMENDS A SPECIAL INCENTIVE DEDUCTION OF 5% OF THE INTEREST ON CERTAIN TYPES OF LOANS WHICH SHOULD BE ENCOURAGED, SUCH AS RESIDENTIAL MORTGAGE LOANS, STUDENT LOANS, AND SBA LOANS. THIS INCENTIVE WOULD BE AVAILABLE TO ALL FINANCIAL INSTITUTIONS.

WE HEARTILY ENDORSE THE POLICY OF THE TREASURY PROPOSALS, BOTH FROM A TAX EQUALITY STANDPOINT AND FROM THE STANDPOINT OF THE ENCOURAGEMENT IT WOULD PROVIDE FOR INCREASED LOANS WHERE THEY ARE NEEDED AND WHERE INTEREST RATES ARE NOW SO HIGH.*

---

* The Treasury proposal provides that the new incentive deduction cannot reduce taxable income below 60 percent of taxable income before the incentive deduction, but increased by the amount of tax-exempt interest and the intercorporate dividend deduction.

EFFECT ON SMALLER BANKS

THE MEMBERSHIP OF THE BANKERS COMMITTEE FOR TAX EQUALITY COMES ALMOST ENTIRELY FROM SMALL COMMERCIAL BANKS. ON DECEMBER 31, 1968, 85% OF ALL THE COMMERCIAL BANKS IN THE UNITED STATES HAD DEPOSITS OF UNDER $25 MILLION AND THEIR AGGREGATE DEPOSITS EQUALED 19% OF TOTAL DEPOSITS, OR $84 BILLION.

RESIDENTIAL MORTGAGES HELD BY ALL COMMERCIAL BANKS IN THE UNITED STATES TOTALED $41 BILLION. IT IS ESTIMATED THAT ABOUT A THIRD OF THE RESIDENTIAL MORTGAGES HELD BY COMMERCIAL BANKS ARE HELD BY SMALL BANKS WITH DEPOSITS UNDER $25 MILLION.

THESE SMALL BANKS WILL BENEFIT MORE THAN THE LARGER BANKS FROM THE TREASURY'S PROPOSAL. GENERALLY, THE SMALLER THE COMMERCIAL BANK THE GREATER WILL BE THE ADVANTAGE OF THE TREASURY PROPOSAL.

THE EFFECT ON EARNINGS OF SAVINGS AND LOAN ASSOCIATIONS AND MUTUAL SAVINGS BANKS WOULD BE MUCH GREATER, AS THEY HAVE A HIGHER PERCENTAGE OF THEIR ASSETS IN RESIDENTIAL MORTGAGES.

BUT THE REAL BENEFICIARY OF THE TREASURY PROPOSAL WILL BE THE HOME BUYER AND RESIDENTIAL TENANT. THE TREASURY PROPOSAL WILL INCREASE COMPETITION FOR RESIDENTIAL LOANS AND THEREBY DRIVE DOWN THE INTEREST RATE. INDEED, IT IS POSSIBLE THAT THE TAX SUBSIDY RECEIVED BY THE FINANCIAL INSTITUTIONS WILL BE LARGELY OFFSET BY THE LOWER INTEREST RATES THEY WILL HAVE TO CHARGE TO COMPETE IN THE MORTGAGE MARKET.

THE TREASURY ESTIMATES THAT THE BENEFITS OF THIS INCENTIVE

WOULD APPROXIMATE THE REVENUE LOSS RESULTING FROM THE REMOVAL OF THE BAD-DEBT RESERVE PROVISIONS.

IF THE HOUSE BILL'S APPROACH IS FOLLOWED

WE HOPE THAT YOUR COMMITTEE WILL ADOPT THE TREASURY PROPOSALS. IN THE EVENT, HOWEVER, THAT THE COMMITTEE DECIDES TO FOLLOW THE HOUSE APPROACH, WE URGE THE FOLLOWING CHANGES:

1. UNDER PRESENT LAW, SAVINGS AND LOAN ASSOCIATIONS AND MUTUAL SAVINGS BANKS ARE ALLOWED ADDITIONS TO THEIR BAD-DEBT RESERVES EQUAL TO 60 PERCENT OF TAXABLE INCOME. THE HOUSE BILL REDUCES THIS TO 30 PERCENT OVER A 10-YEAR PERIOD. SINCE THIS STILL WOULD GIVE THESE INSTITUTIONS A SUBSTANTIAL TAX ADVANTAGE OVER COMMERCIAL BANKS, WE RECOMMEND THAT THIS TAX SUBSIDY BE REDUCED TO 20 PERCENT, OR LESS, BY THE END OF THE 10-YEAR PERIOD.

2. PRESENT LAW PROVIDES THAT ADDITIONS MAY BE MADE TO THE BAD-DEBT RESERVES OF MUTUAL THRIFT INSTITUTIONS UNTIL THE RESERVE REACHES 6 PERCENT OF QUALIFYING REAL PROPERTY LOANS. THIS CEILING PERMITS THE ACCUMULATION OF EXCESSIVE BAD-DEBT RESERVES AND SHOULD BE REDUCED TO 4 PERCENT OR LESS.

3. THE HOUSE BILL PERMITS THE FULL BENEFIT OF THE SPECIAL BAD-DEBT RESERVE PROVISIONS TO SAVINGS AND LOAN ASSOCIATIONS ONLY IF THEY INVEST 82 PERCENT OF THEIR FUNDS IN CERTAIN QUALIFYING ASSETS, INCLUDING RESIDENTIAL REAL PROPERTY LOANS. MUTUAL SAVINGS BANKS MUST INVEST 72 PERCENT OF THEIR FUNDS IN QUALIFYING ASSETS TO OBTAIN SIMILAR BENEFITS. TO ASSURE THAT THESE SPECIAL TAX

SUBSIDIES ARE LIMITED TO CASES WHERE THE INSTITUTIONS CHANNEL THEIR FUNDS INTO THE INTENDED ASSETS, WE RECOMMEND THAT BOTH SAVINGS AND LOAN ASSOCIATIONS AND MUTUAL SAVINGS BANKS BE REQUIRED TO INVEST 85 PERCENT OF THEIR FUNDS IN QUALIFYING ASSETS IN ORDER TO OBTAIN THE FULL TAX ADVANTAGE. MOREOVER, THE DEFINITION OF "QUALIFYING ASSETS" SHOULD BE REVISED SO THAT IT DOES NOT INCLUDE CASH AND GOVERNMENT BONDS.

CONCLUSION

THE BANKERS COMMITTEE FOR TAX EQUALITY WAS FOUNDED BY COMMERCIAL BANKS 20 YEARS AGO FOR THE SOLE PURPOSE OF HELPING TO CREATE EQUALITY OF TAXATION FOR ALL TYPES OF COMPETING BANKING INSTITUTIONS. WE HOPE THAT THIS YEAR'S TAX REFORM WILL GIVE US EQUITY AND THAT THE BANKERS COMMITTEE FOR TAX EQUALITY WILL HAVE COMPLETED ITS TASK.

* * * * * * *

Summary of Principal Points
Included in the Statement
of the
National Association of Mutual Savings Banks
on
The Taxation of Mutual Savings Banks
Before the
Committee on Finance
United States Senate
September 15, 1969

Mr. Chairman and members of the Committee, my name is Edward P. Clark. I am President of the Arlington Five Cents Savings Bank of Arlington, Massachusetts, and Chairman of the Committee on Taxation of the National Association of Mutual Savings Banks. With me are Dr. Grover W. Ensley, Executive Vice President of the Association; Dr. George Hanc, Director of Research; and Mr. Jack S. Older, Assistant General Counsel.

There are now before you two proposals to revise the tax treatment of financial institutions -- the one included in H.R. 13270, passed by the House on August 7, the other included in the Administration's statement on this bill, presented to this Committee on September 4. Although different in basic approach, the proposals have in common an especially harsh impact on mutual thrift institutions and, hence, on mortgage and housing markets. Thus, while their stated intent is to stimulate, their effect is to reduce, the flow of credit into housing and other socially desirable uses.

The Administration Proposal

In addition to this intent, the Administration proposal attempts to achieve equity of taxation between mutual thrift institutions and commercial banks. It fails on both counts. The proposal gives with one hand a "special tax deduction" related to the gross income from designated, socially desirable investments, while with the other hand takes away the bad debt reserve allowance currently permitted thrift institutions. The

taking away far more than offsets the giving, and hence materially discourages residential lending.

The proposal -- however well-intended -- backfires because thrift institutions need no special "incentives" to channel funds into areas such as housing where they are already heavily invested. It backfires because, without a realistic bad debt reserve allowance to protect against potential losses, prudent thrift institutions must seek less risky investments, and ultimately many would convert into commercial banks to gain broader powers.

The proposal backfires, moreover, because the special deduction is so circumscribed as to limit its usefulness to many savings banks, and so designed as to fall with widely varying impact on individual institutions, not necessarily in relation to their residential lending activity. The savings bank industry, as a whole, would qualify (after the transition period) for a special deduction of less than 10 per cent of "economic income," while roughly half of all savings banks would have no special deduction at all. This, in spite of the fact that the bulk of savings bank assets would be in socially desirable loans, as defined by the Administration.

The Administration proposal could be modified to achieve its stated objective with respect to mutual savings banks, but not without altering its basic structure. This is so because: (1) a realistic bad debt reserve provision would need to be included, along the lines of the present law or of the proposed House bill with appropriate changes, and (2) the 60 per cent limitation would need to be eliminated or substantially reduced.

No one can quarrel with the concept of equity as a basic objective of tax legislation. But equitable tax treatment does not necessarily

mean identical treatment. In fact, when applied to unequal institutions, identical treatment is inequitable. This is the effect of the Administration proposal to tax thrift institutions and commercial banks under the identical formula. The intent of the proposal may be to achieve tax equity; the result, in fact, would be to aggravate already existing competitive inequalities stemming from the substantially broader range of powers, greater flexibility and profitable use of interest-free demand deposits enjoyed by commercial banks.

Equality of tax treatment without equality of competitive opportunities does in fact place a disproportionately heavy tax burden on thrift institutions. The burden is even heavier than it appears from the Administration statement, because the effective tax rate for mutual thrift institutions would be higher if "economic income" reflected realistic deductions for potential long-term mortgage portfolio losses.

Such realistic bad debt reserve allowances recognize the greater reserve needs of institutions whose assets are dominated by long-term loans, than of commercial banks with predominantly short-term loan portfolios. To be sure, mortgage loan losses have been unusually low during the postwar inflationary economic boom. But history indicates that losses tend to be concentrated and substantial during short periods of time. Such losses generally occur during economic recessions and declining values, but could also occur when real estate values and prices are relatively stable, rather than rising as in recent years. Surely, prudent lenders must be prepared for such an eventuality.

Heavier tax burdens imposed on mutual thrift institutions would clearly weaken their ability to compete with commercial banks and hence reduce the supply of funds for housing and inner city rebuilding. In

sum, Administration fears that the House-passed tax revisions would limit "free and open competition between thrift institutions and commercial banks" more aptly apply to its own proposals. If the Congress, however, decides to impose excessively burdensome tax provisions on thrift institutions, then the Congress should also permit mutual savings banks the powers to compete effectively with commercial banks.

The House-Passed Proposal

One objection to the House-passed tax provision is that it imposes a relatively narrow investment standard on mutual savings banks. The need for investment flexibility for mortgage-oriented institutions is widely recognized as essential to strengthening their ability to attract savings and generate an expanded supply of mortgage credit over the economic cycle. By liquidating nonmortgage investments, savings banks were able to channel an amount equivalent to 108 per cent of deposit growth into mortgage loans during the 1966 credit crunch, and over 100 per cent in the first seven months of 1969. The importance of such flexibility was reemphasized in a major Congressionally authorized study just completed for the Federal Home Loan Bank Board under the direction of Professor Irwin Friend. It seems clear that the objective of encouraging expanded mortgage flows can be better accomplished by not establishing narrow investment standards. Furthermore, flexible powers for financial institutions are better geared to meeting the nation's changing social and economic priorities over the years.

We do, of course, understand that the objective of the House measure is to relate bad debt reserve allowances to investments in specific types of assets. The House does, however, recognize the need of mortgage-oriented thrift institutions for bad debt reserve allowances different

from those of nonmortgage-oriented commercial banks. If the Congress feels that an investment standard should be imposed on savings banks for the first time, we urge that it be broadened to include all types of mortgage lending, which are essential to the rebuilding of our urban areas.

We urge additional revisions in the House bill. Our recommendations in this respect are detailed in the comprehensive statement submitted to this Committee, which we request be included in the printed record of these hearings. In particular, we strongly believe that the present 60 per cent maximum percentage of income bad debt reserve allowance be retained, rather than reduced to 30 per cent, in order to avoid a further major reduction in housing credit.

Conclusion

All things considered, the savings bank industry firmly believes that the present tax provisions for mutual savings banks accomplish for housing exactly what the Congress intended -- a strong stimulus to residential mortgage flows. The proposed changes, if enacted, would be particularly unfortunate at the present time when housing and mortgage credit are already depressed and likely to deteriorate further. It is important to note that current tax obligations of savings banks are rising and will rise significantly further without changing the present tax laws.

The National Association of Mutual Savings Banks has given careful consideration to the two proposals before this Committee to revise the tax treatment of financial institutions. We believe that, contrary to their own stated objectives, they would have a seriously adverse effect on the flow of credit into housing and other socially desirable uses. Of the two, however, we believe the House-approved measure as modified in our statement, would be less harmful to housing.

Table 1

Composition of Assets and Liabilities
of Mutual Savings Banks
June 30, 1969

(amounts in millions of dollars)

Assets and Liabilities	Amounts	Per Cent of Assets
Cash	$ 865	1.2%
U. S. Government Securities	3,618	4.9
Federal Agency Securities	1,939	2.6
State and Local Government Securities	192	.3
Corporate and Other Bonds	6,983	9.5
Corporate Stock	2,107	2.9
Mortgage Loans	54,672	74.6
FHA	15,910	21.7
VA	12,356	16.9
Conventional	26,407	36.0
Other Loans	1,633	2.2
Other Assets	1,306	1.8
TOTAL ASSETS	$ 73,316	100.0%
Deposits	66,243	90.4
Other Liabilities	1,664	2.3
General Reserves	5,409	7.4
TOTAL LIABILITIES AND RESERVES	$ 73,316	100.0%

Note: Breakdown of mortgage holdings is partially estimated on the basis of data for the end of 1968.

Source: National Association of Mutual Savings Banks.

Table 2

Mortgage Loans Held by Mutual Savings Banks in
Selected Nonsavings Bank States
October 31, 1962 and September 30, 1968
(Amounts in millions of dollars)

State	October 31, 1962	September 30, 1968
California	2,196	4,725
Texas	987	1,483
Florida	1,070	1,462
Virginia	604	1,176
Georgia	361	722
Louisiana	251	465
Michigan	340	455
Tennessee	221	412
Arizona	351	364
Illinois	163	342
Oklahoma	194	280
Missouri	141	228
New Mexico	126	171
Utah	98	151
Kentucky	84	135
Arkansas	24	82
Kansas	68	81
Nebraska	34	73
Idaho	4	27
Iowa	13	25
Montana	2	8
Other Nonsavings Bank States	958	2,211
Total Nonsavings Bank States	8,290	15,078
Total Mortgage Holdings	31,583	52,410

SOURCE: National Association of Mutual Savings Banks.

Accomplishments of the 1962 Tax Law

As we testified before the House Ways and Means Committee, we believe that the present provisions of the Internal Revenue Code affecting mutual savings banks, which were enacted in 1962, accomplished for housing exactly what the Congress intended -- a strong stimulus to residential mortgage flows.[1/] They have permitted mutual savings banks to establish realistic bad debt reserve allowances in light of the risks incurred by mortgage-oriented thrift institutions which "borrow short and lend long," primarily on residential real estate. In this regard, Treasury Department data indicate that mutual savings banks since 1962 have actually had smaller bad debt reserve deductions, relative to loan growth, than either savings and loan associations or commercial banks (Table 3).

The strong stimulus provided by the present law to the flow of mortgage credit, particularly for FHA and VA mortgage loans and for urban revitalization programs, is indicated by the record of the savings bank industry since 1962. From the end of 1962 to the end of 1968, mutual savings banks increased: (1) their total mortgage holdings by $21 billion; (2) their overall ratio of mortgage loans to total assets from 69.5 to 74.9 per cent (Table 4); and (3) their FHA and VA mortgage portfolios by $8.6 billion, far more than the combined expansion in FHA and VA mortgage holdings for all other private institutional lenders (Table 5). By liquidating nonmortgage investments, mutual savings banks were able to channel into mortgage loans an amount equivalent to 108 per cent of their deposit growth during the credit crunch of 1966. More recently, in the first seven months of 1969, another period of mortgage credit stringency, mortgage

1/ See Tax Reform, 1969, Hearings Before the Committee on Ways and Means, House of Representatives, 91st Congress, 1st Session, Part 10, March 24, pp. 3469-3507, hereinafter referred to as "Tas Reform Hearings."

Table 3

Deductions for Bad Debts Relative to Growth in "Eligible" or "Qualifying" Loans
Mutual Savings Banks
Savings and Loan Associations and
Commercial Banks
1963-66

(Amounts in millions of dollars)

	Mutual Savings Banks	Savings and Loans	Commercial Banks
1. Deductions for bad debts for tax purposes, 1963-66	$ 431	$ 1,991	$ 2,862
2. Increase in "eligible" or "qualifying" loans, 1963-66	15,137	35,677	81,251
3. Ratio of #1 to #2	2.85%	5.58%	3.52%

Note: Data for #1 are from Tax Reform Studies and Proposals, U. S. Treasury Department, Committee on Ways and Means of the United States House of Representatives and Committee on Finance of the United States Senate, 91st Congress, 1st Session, February 5, 1969, Part 3, Table 3, p. 473. Data for #2 refer to the increase in eligible loans of commercial banks from the same source, Table 4, p. 474, and to increases in mortgage loans held by mutual savings banks and savings and loan associations, as reported in the Federal Reserve Bulletin.

33-758 O-69—No. 4—6

Table 4

Mortgage-Asset Ratio and Mortgage Lending by Mutual Savings Banks 1962-68

(amounts in millions of dollars)

	Mortgage Holdings	Total Assets	Mortgage-Asset Ratio	Net Increase in Mortgage Holdings	Gross Mortgage Acquisitions
1962	$32,056	$46,121	69.5%	$3,155	$6,245
1963	36,007	49,702	72.4	3,951	7,706
1964	40,328	54,238	74.4	4,322	8,500
1965	44,433	58,232	76.3	4,105	8,654
1966	47,193	60,982	77.4	2,759	7,066
1967	50,311	66,365	75.8	3,118	7,417
1968	53,286	71,152	74.9	2,798	7,015

Note: Data on mortgage holdings, total assets and mortgage-asset ratio are as of year-end.

Source: National Association of Mutual Savings Banks.

Table 5

Holdings of FHA and VA Mortgage Loans
by Main Types of Institutional Lenders
1962-68

(amounts in millions of dollars)

	Total Institutional Lenders	Mutual Savings Banks	Commercial Banks	Savings and Loan Associations	Life Insurance Companies
			Holdings, end of year		
1962	$56,256	$19,025	$ 9,174	$11,486	$16,571
1963	59,954	21,174	9,967	11,656	17,157
1964	62,929	23,408	10,057	11,577	17,887
1965	65,486	25,199	10,390	11,543	18,354
1966	66,094	25,971	10,143	11,428	18,552
1967	67,707	26,869	10,405	12,150	18,283
1968	69,903	27,602	10,634	13,670	17,997
			Change in Holdings, 1963-68		
Amount	$13,647	$ 8,577	$ 1,460	$ 2,184	$ 1,426
Percentage Distribution	100.0%	62.8%	10.7%	16.0%	10.4%

Note: Data on changes in holdings are for the period from the end of 1962 to the end of 1968.

Source: Board of Governors of the Federal Reserve System.

holdings of mutual savings banks rose by $1.6 billion, an amount equivalent to over 100 per cent of their deposit growth.

Furthermore, tax payments of mutual savings banks are rising and will continue to rise without any change in the present law because of the declining importance of the largely temporary factors that reduced tax payments in past years. These factors were: (1) the widespread use of the present 3 per cent bad debt reserve provision which allows mutual savings banks, in general, to deduct 3 per cent of mortgage loan growth; (2) huge losses on the sale of bonds undertaken to meet liquidity needs and provide funds for mortgage lending; and (3) sharp increases in interest payments to depositors.

Many mutual savings banks, however, are shifting from the 3 per cent method to the 60 per cent of income method because their mortgage-asset ratios are now stabilizing at high levels. Losses on bond sales should assume smaller proportions as mortgage-asset ratios stabilize. As mortgage repayments are reinvested at higher interest rates, net earnings are increasing. And savings banks are seeking to strengthen their total general reserves through increased earnings retention. All of these factors are contributing to increased taxable incomes and tax payments under the present law.

Impact of Proposed Tax Changes

Before this Committee now are two proposals for revising the tax treatment of financial institutions -- sections 441-443 of the House-passed Tax Reform bill (H.R 13270) and the Administration proposal presented to this Committee on September 4. These proposed changes differ in certain basic respects. As between the two proposals, we believe that the House bill, despite its serious adverse effects on housing credit, would provide

a better basis for the taxation of mortgage-oriented thrift institutions, assuming that the Congress decides that the present tax law must be changed. This is because it would appear to be more feasible to modify the House bill, as indicated later in this statement, in order to reduce its harmful impact on housing and urban revitalization programs, while, at the same time, significantly increasing tax payments of all financial institutions. As also noted later, the modifications needed to reduce the Administration proposal's adverse impact on housing credit would require basic changes in its structure.

It should be reemphasized, however, that, in our judgement, both proposed changes -- especially the Administration proposal, but also the House bill if our suggested modifications are not adopted -- would have similar, harmful effects on mortgage oriented thrift institutions, savings depositors and housing and urban revitalization programs.

First, in view of the much broader powers enjoyed by competing commercial banks, enactment of either proposal would place a disproportionate burden of increased tax payments on mutual thrift institutions, the main source of housing credit. Commercial banks presently have powerful competitive advantages, including a wider range of financial services, authority to make high-yield business and consumer loans, the greater flexibility inherent in short-term lending, the ability to acquire capital through the sale of stock, ability to tap wide sources of loanable funds, and the profitable use of interest-free demand deposit and money creation powers. If mutual thrift institutions pay taxes at the effective rates contemplated by these proposals, they would be placed at a serious competitive disadvantage relative to commercial banks. In this regard, the House bill is

apparently designed to raise the effective rate of taxation more sharply for thrift institutions than for commercial banks. With respect to the Administration proposal, Assistant Secretary Cohen indicated in response to questioning by Committee members, that thrift institutions and commercial banks would all pay taxes at an effective rate of about 29 per cent of "economic income" (assuming that they have sufficient gross income from residential mortgages and other qualifying loans under the 5 per cent provision discussed later).

In actuality, such comparisons of effective rates of taxation, based on so-called "economic income," greatly underestimate the increased tax burden on mutual thrift institutions, and, therefore, the harmful consequences for housing. "Economic income," as used by Treasury officials, is not defined in the tax law. It does not reflect any deduction for bad debt reserves (except as determined by recent loss experience). If a realistic allowance for potential mortgage losses were deducted, projected tax payments could then be related to a more meaningful and considerably lower amount of "economic income." The resulting effective tax rates of thrift institutions would then be even higher than Treasury officials suggest.

Such a realistic bad debt reserve allowance would reflect the greatly different reserve needs of mutual thrift institutions whose assets are dominated by long-term mortgage loans, as contrasted with commercial banks whose portfolios are dominated by short-term loans. It would also reflect accurately the potential losses on mortgage loans. To be sure, losses have been unusually low during the inflationary postwar economic boom, reflecting in large part the sharp and prolonged rise in real estate values and burgeoning housing demands since the end of World War II. In a

period of serious economic decline, or even a period of extended stability in real estate values and overall prices, however, greater losses can be anticipated. Mortgage losses during the depression of the 1930's were extremely high. Massachusetts savings banks during the 1931-45 period sustained mortgage losses equivalent to 17.4 per cent of average mortgage holdings for the period, and 14.3 per cent of holdings as of the end of 1930.[2] While a depression of the magnitude experienced in the 1930's is not expected, a future severe recession, accompanied by significantly increased losses on mortgage loans, cannot be ruled out. Furthermore, it must be recognized that in a period of relatively stable prices and real estate values, which we hope can be achieved, greater mortgage losses must be expected.

Thus, the proposed tax changes would impose levels of taxation on thrift institutions that: (1) ignore the broader powers and competitive advantages of commercial banks; and (2) are in actuality considerably higher than is suggested by "economic income" comparisons. The increased tax burden imposed by these proposals would weaken the ability of mutual thrift institutions to compete with nonmortgage-oriented commercial banks. It would also reduce their ability to maintain adequate reserves needed for protection against potential losses on long-term residential loans and to meet requirements of supervisory authorities. Unlike commercial banks which have the option of selling new stock to acquire additional capital, mutual savings banks can accumulate protective reserves only through the retention of earnings.

Second, enactment of either the provisions in the House bill in its present form or the Administration proposal would reduce, rather than

2/ Tax Reform Hearings, p. 3488.

stimulate, the supply of mortgage credit for housing and urban revitalization programs. This reduction would result from a combination of forces stimulated in varying degrees by the two proposals. The weakened competitive position of mutual thrift institutions would lead to a diversion of the flow of saving to nonmortgage-oriented commercial banks. As discussed more fully later, the Administration proposal would eliminate any bad debt reserve allowance (other than that provided by recent loss experience) and deny to many savings banks the "special deduction" proposed as a substitute. The resulting reduced ability of mutual thrift institutions to set aside realistic bad debt reserve allowances for long-term mortgage loans would stimulate shifts of funds to less risky nonmortgage investments. Ultimately, many thrift institutions would be compelled by competitive pressures to convert into commercial banks, and adopt their nonmortgage lending pattern. Even if there should be any increase in mortgage lending by commercial banks -- which is doubtful because of their basic, short-term nonmortgage orientation -- this would be far outweighed by reduced mortgage flows from thrift institutions. Reflecting fundamental differences in investment orientation, mortgage loans represent about 75 per cent of mutual savings bank assets, compared with only 14 per cent of commercial bank assets.

The resulting reduction in funds for housing and urban revitalization would represent a cost to the nation which, in our judgement, would far outweigh any immediate increase in the tax payments of mutual thrift institutions. Moreover, due to their weakened competitive position and reduced ability to set aside needed reserves for future mortgage losses, we doubt that mutual thrift institutions in the long-run would be able to attract the volume of saving apparently expected. With reduced rates of growth in resources, their taxable incomes and tax payments could fall

short of projected amounts. Estimates of increased revenue resulting from enactment of these proposals apparently assume continuation of strong rates of growth at these institutions. It is hazardous to make any such assumption in view of the fierce competition for savings. We are not attempting here to make any revenue estimates, but we feel it is reasonable to believe that if the present law were retained, and mutual thrift institutions were allowed to compete more effectively for savings, there would be more money for housing, higher incomes for thrift institutions, and an increasing volume of tax payments by thrift institutions in the years ahead.

We recognize, however, that there are strong pressures for changes in the tax treatment of financial institutions, including mutual savings banks. If this Committee, after considering the harmful effects on housing, concludes that mutual thrift institutions should be taxed more heavily, we urge that certain modifications in the House bill be adopted to reduce its adverse consequences for housing and urban revitalization programs.

Needed Modifications in the Provisions of the House Bill

As passed by the House, section 442 of H.R. 13270 would make the following changes in the bad debt reserve provisions of mutual savings banks:

1. Repeal the present 3 per cent provision which permits these institutions, in general, to deduct 3 per cent of the growth in their mortgage holdings as an addition to bad debt reserves; and
2. Reduce the alternative percentage of income bad debt reserve allowance by:
   a. Lowering the maximum allowance from 60 per cent of taxable income to 30 per cent over a ten year transition period;

b. Permitting mutual savings banks to qualify for the maximum allowance only if they have 72 per cent of their total assets in certain specified types of qualifying assets;

c. Lowering the maximum allowance for mutual savings banks that do not meet the 72 per cent standard according to a sliding scale provision; and

d. Denying any percentage of income deduction to mutual savings banks that have less than 60 per cent of their total assets in qualifying assets.

Similar changes were made in the bad debt reserve provisions of savings and loan associations. Under section 441 of the House bill, commercial banks would no longer be permitted to accumulate bad debt reserves up to 2.4 per cent of eligible loans and would be required to deduct additions to bad debt reserves on the basis of actual loss experience only.

The modifications we urge in the House bill are as follows:

1. Eliminate the 72 per cent investment standard;

2. If elimination of the investment standard is contrary to Congressional policy, then change the standard in these three ways:

   a. Broaden the list of qualifying assets to include all mortgage loans which are essential to residential living and the rebuilding of our decaying urban centers;

   b. Revise the sliding scale provision which requires a reduction of the percentage of income bad debt deduction for each percentage point a savings bank is below the 72 per cent standard in order to reduce the penalty imposed in the earlier years for which the new provisions will be effective; and

c. Eliminate the provision which denies any percentage of income deduction to savings banks with less than 60 per cent of their total assets in qualifying assets; and

3. Retain the 60 per cent maximum percentage of income deduction rather than reduce it over a ten-year period.

Elimination of the 72 per cent investment standard for savings banks would be consistent with widespread, bipartisan, public and private recognition that increased investment flexibility for mortgage-oriented thrift institutions is the best means of strengthening their ability to attract savings and generate an expanded long-run supply of mortgage credit.[3/] The importance of investment flexibility for mortgage-oriented thrift institutions was demonstrated dramatically during the 1966 mortgage credit crisis. Because of their broader investment powers, mutual savings banks were better able than savings and loan associations to compete for savings, meet liquidity pressures and satisfy local mortgage credit demands. Flexible investment powers, moreover, have permitted mutual savings banks to adjust their lending policies to meet the nation's continually changing social and economic priorities. The importance of investment flexibility was reemphasized in a major, Congressionally-authorized study just completed for the Federal Home Loan Bank Board under the direction of Professor Irwin Friend.[4/]

As Secretary Kennedy testified before this Committee on September 4:

> "[Investment] restrictions limit the ability of the thrift institutions to compete for savings during periods of tight money. They also fail to recognize other important national goals."

While we strongly believe that elimination of the 72 per cent investment standard is desirable, we recognize that the House sought to

---

3/ Tax Reform Hearings, pp. 3491 and 3492.

4/ Irwin Friend, Study of the Savings and Loan Industry; Summary and Recommendations, Prepared for the Federal Home Loan Bank Board, Washington, D. C., September, 1969.

to relate the percentage of income bad debt reserve allowance to investments in certain types of assets. If this requirement is retained, the list of assets qualifying under the 72 per cent standard should be broadened to include all mortgage loans, which are essential in rebuilding our urban centers. At the very least the standard should include the types of loans indicated below.

The House bill now includes loans made to improve commercial property in urban renewal and Model Cities areas and loans secured by educational, health, and welfare facilities. It does not go far enough, however, since numerous other supplementary and supportive facilities are essential adjuncts to family living in all areas. Individuals and families must have ready access to shopping and service facilities for food and clothing, as well as facilities for the repair and servicing of household appliances and automobiles. Moreover, in urban renewal and Model Cities areas, there is a critical need for job-creating facilities, such as factories, office buildings, warehouses, industrial parks and transportation facilities.

Furthermore, the House bill includes mobile homes not used on a transient basis, but does not include the mobile home parks in which qualifying mobile homes will be located. In many sections of the country the development of mobile home parks is vital in helping to provide low-cost housing sites.

Individuals and families transferring to new areas because of better job opportunities often need to use transient living facilities when permanent facilities are not immediately available. Thus, hotels and motel facilities are also essential parts of the total living environment in our society which is marked by a high degree of mobility and wide ranging opportunity.

Therefore, we suggest that the list of assets qualifying for purposes of meeting the 72 per cent investment standard be broadened to include all mortgages, particularly the following:

1. Loans secured by shopping and service facilities;
2. Loans secured by property in any urban renewal area (as defined in section 110 (a) of the Housing Act of 1949, as amended) or in any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended. This would be in addition to loans for the improvement of such properties already included in the bill;
3. Loans secured by mobile home parks; and
4. Loans secured by hotels and motels.

In addition, several technical problems must be solved in drafting a final version of the investment standard. These problems are discussed in the Appendix following this statement.

As to the revision of the sliding scale provision, the House bill provides that a mutual savings bank with less than 72 per cent of its total assets in qualifying assets would be required to reduce the maximum percentage of income bad debt deduction by a certain number of percentage points for each percentage point that its ratio of qualifying assets falls below the standard. In the first two years for which the new law would be effective, the reduction in reserve allowances is two percentage points for each one percentage point below the 72 per cent standard. For the next five years the reduction would be 1-1/2 points for each point below the standard, and thereafter the reduction would be on a one-for-one basis. A sliding scale is essential if the 72 per

cent standard is retained since about one-fifth of the savings banks have qualifying asset ratios below 72 per cent of total assets. It is clear, however, that the specific sliding scale provision in the House bill works a greater hardship on mutual savings banks in the initial years for which the new provision would be effective.

This is neither reasonable nor equitable. Many mutual savings banks would seek to alter the composition of their assets to meet the investment standard. As long-term lenders, they would need many years to make the necessary changes, and should not be penalized while attempting to shift their assets in line with the objectives of the bill. Thus, it would be more equitable to revise the sliding scale provision so that the reduction would be permanently one percentage point in the reserve allowance for each one percentage point that an institution's qualifying asset ratio is below the 72 per cent standard.

Deletion of the provision denying the percentage of income bad debt reserve deduction to savings banks with less than 60 per cent of total assets in qualifying assets is desirable since, otherwise, these institutions would be allowed bad debt deductions only on the same basis as commercial banks, without having the broad powers and competitive advantages enjoyed by commercial banks. They might be forced to convert into commercial banks in order to preserve their competitive viability. While the number of mutual savings banks involved is small, a significant reduction in housing credit could result in certain local market areas. Our recommended deletion would provide some small percentage of income deduction for these mutual savings banks below 60 per cent, while they seek to increase their mortgage holdings and qualify for higher reserve allowances.

Finally, we believe that the present reserve allowance of 60 per cent of income is justified for all mortgage-oriented thrift institutions, and should not be reduced to 30 per cent as provided in the House bill. As long-term lenders, both mutual savings banks and savings and loan associations are especially vulnerable to large-scale losses in a severe economic recession, despite the favorable experience of recent times. They must accumulate adequate reserves during periods of prosperity to meet the losses that can occur if real estate markets undergo a severe decline.

The need for adequate reserves would not be obviated by the provision in the House bill permitting financial institutions to carry back net operating losses for ten years, rather than three years as in the present law. While this provision is desirable for the long run and should be retained, it would have little practical application in the immediate future. Taxable incomes of mutual savings banks have been small in relation to loan holdings, and tax refunds would not compensate for potential loan losses.

Retention of the present 60 per cent bad debt reserve allowance would permit savings banks to compete more effectively for savings and provide more mortgage credit, while generating an increasing volume of tax revenue. Recently available industrywide figures suggest that savings banks, operating increasingly under the 60 per cent provision in the present law, expect to pay four or five times as much tax in 1969 as in 1967, without any change in the present law.

The Administration Proposal

The Administration proposal provides a basically different approach to the taxation of financial institutions than the House bill. As Treasury officials testified before this Committee, the Administration proposal would:

1. Eliminate any bad debt reserve allowance for thirft institutions (other than that provided by recent loss experience) and substitute a "special deduction" for thrift institutions and commercial banks of 5 per cent of gross interest income on residential and certain other loans;
2. Limit this special deduction so that it could not reduce taxable income below 60 per cent of taxable income adjusted to include the full amount of dividend income and tax-exempt interest; and
3. Phase in the increased tax burden on mutual savings banks and savings and loan associations over a five-year period, instead of the ten-year transition period provided in the House bill.

Commercial banks would tend to be more lightly taxed under the Administration proposal than under the House bill. Among thrift institutions, the burdon of increased taxation would tend to be shifted under the Administration bill toward institutions that have utilized flexible investment powers, contrary to the stated objective of the Administration as indicated by Secretary Kennedy before this Committee.

The special deduction is designed to encourage the flow of funds into residential construction and other socially preferred uses. In view of their basic, long-standing mortgage orientation, mutual savings banks need no special inducement to invest in residential mortgage loans. Nor do they seek any such inducement. Rather, as indicated earlier, mutual savings banks seek a bad debt reserve allowance that will realistically reflect the risks involved in long-term mortgage lending. A realistic reserve allowance -- that would enable thrift institutions to set aside needed reserves in the light of potential mortgage losses, and enable them

to compete effectively for savings -- is a far better means of encouraging an adequate flow of mortgage credit.

Even apart from these considerations, the special deduction would provide a highly imperfect incentive for channeling funds into these uses because of the 60 per cent limitation. It would vary widely in a manner unrelated to the institution's residential mortgage lending activity. Two institutions having identical proportions of assets in mortgages and experiencing identical rates of growth in mortgage holdings might qualify for greatly different special deductions. The highly variable incentive for residential mortgage lending provided by the special deduction proposed by the Administration contrasts with the present law, since bad debt reserve deductions under the 3 per cent provision are geared precisely to mortgage growth and under the percentage of income allowance are limited by the ceiling of 6 per cent of real property loans.

Based on published balance sheet data and reasonable assumptions regarding yields on various types of assets, the savings bank industry as a whole would qualify (after transition periods are completed) for a special deduction of less than ten per cent of "economic income." Indeed, many savings banks -- as a rough estimate, about one-half of our institutions -- would have no special deduction under the Administration proposal. Despite the fact that the overwhelming proportion of their assets are in residential mortgage loans, these institutions would be taxed in the same manner as nonfinancial corporations and would be denied the special deduction designed by the Administration specifically for financial institutions and to encourage real estate lending. In contrast, under the House bill, only about 2 per cent of the savings banks would be denied the percentage of income bad debt reserve deduction.

33-758 O-69—No. 4—7

Enactment of the Administration proposal in the form presented to this Committee would lead to major changes in assets and structure by many mutual savings banks. Denied both a realistic bad debt reserve deduction, and in many cases, the proposed special deduction, many institutions would shift funds from mortgages into less risky investments. Ultimately, many mutual thrift institutions would convert into commercial banks in order to acquire the broader powers commercial banks enjoy. State laws of many savings bank states already permit such changes. Indeed, the second largest mutual savings bank in New Hampshire, motivated, in part, by apprehension regarding rumored savings bank tax changes, has already taken steps to convert into a commercial bank. Where present legal authority is lacking, permissive legislation would undoubtedly be sought.

The result of such changes, both immediately and in the long run, would be a reduction in the flow of mortgage credit into housing and urban revitalization programs, as some mutual thrift institutions shift funds to nonmortgage investments and others convert into commercial banks and adopt their nonmortgage lending pattern. As noted earlier, the increased overall tax burden on mutual thrift institutions, in the face of the competitive advantages of commercial banks, would further reduce the supply of housing credit. Taking all these effects into account, we believe that the Administration proposal would fail to achieve its stated objective of encouraging the flow of funds into residential mortgages and other loans made pursuant to national objectives. It would certainly result in major changes in our industry's financial structure.

We do not believe that the Administration proposal can be modified in a manner that would result in realistic tax provisions for mutual thrift institutions, while retaining its present structure, because it has two principal defects:

1. The fact that the Administration proposal does not provide a realistic bad debt reserve provision for mortgage-oriented thrift institutions; and
2. The fact that the special deduction proposed as a substitute for a bad debt reserve allowance would not be available, in practice, to many savings banks.

To correct the first defect, it would be necessary to adopt an approach similar either to the present law or to the House bill with the modifications we have suggested. To correct the second defect, it would be necessary to remove the 60 per cent limitation, or reduce it to a considerably lower figure, and to make additional changes in the 5 per cent provision. A major restructuring of the Administration proposal would be necessary, therefore, to provide a reasonable basis for taxing mutual thrift institutions. Such a major restructuring seems impractical. Therefore, we believe that the House bill, despite its seriously adverse effects on housing credit, could provide a better basis for the taxation of mortgage-oriented thrift institutions, assuming that the Congress decides that the present tax law must be changed.

Conclusion

The savings bank industry reiterates that the present law enacted in 1962 accomplished for housing exactly what the Congress intended -- a strong stimulus to residential mortgage flows -- and will provide an increasing flow of tax revenue from thrift institutions in future years. We recognize that the Congress may, nevertheless, decide to impose heavier taxation on thrift institutions. Therefore, we have suggested what we believe to be constructive recommendations for modification of the House

bill which would reduce the harmful impact on housing and other vital national programs.

If the Congress, however, decides to impose excessively burdensome tax provisions on thrift institutions -- especially the Administration proposal, but also the House provisions without the modifications suggested in this statement -- then the Congress should also permit mutual savings banks the powers needed to compete effectively with commercial banks.

APPENDIX

Technical Considerations Relating to Section 442
(Mutual Savings Banks, etc.) of H.R. 13270

Section 442 (a) of H.R. 13270 (Tax Reform Act of 1969) would change section 593 (b) of the Internal Revenue Code of 1954 which provides rules for the allowance of tax deductible bad debt reserve additions by mutual savings banks and savings and loan associations. There are basically two changes: (1) repeal of the 3 percent method which allows thrift institutions to deduct 3 percent of their mortgage loan growth, and (2) modification of the percentage of taxable income method which allows them to deduct 60 percent of taxable income. The modification of the percentage of taxable income method, as set forth in section 442, presents certain technical problems.

Section 593 (b) (2) and (3) of the Code would be amended to permit a mutual savings bank to take the maximum percentage of taxable income deduction only if 72 percent of its total assets are assets described in section 7701 (a) (19) (C) of the Code. Section 442 (b) of H.R. 13270 would amend section 7701 (a) (19) (C) of the Code to describe the assets which must comprise 72 percent of total assets. It should be noted that the purpose of section 7701 (a) (19) is to define a "Domestic Building and Loan Association," and that mutual savings banks are for the first time affected by subparagraph (C) of section 7701 (a) (19) for purposes of an investment standard rather than a definition. This necessitates some clarification to make sure that mutual savings banks are given equitable treatment with respect to determining the qualifying assets they hold for purposes of the investment standard.

For example, section 7701 (a) (19) (C) (iv) as amended, refers to "loans secured by a deposit or share of a member." It should be made clear

that loans secured by a deposit in a mutual savings bank, as well as a savings and loan association, are in this category. Mutual savings banks do not have members, and recently, savings and loan associations were permitted to amend their charters to have their account holders denominated as depositors rather than members.

Section 7701 (a) (19) (C) (x) refers to "property used by the association in the conduct of the business described in subparagraph (B)." It should also be made clear that property used by a savings bank in the conduct of its business qualifies.

Furthermore, section 7701 (a) (19) (C) (v) refers to "loans secured by an interest in real property which is...residential real property..." Savings banks make loans secured by large apartment houses. These apartment houses often contain space for stores or offices which are essential adjuncts to residential living in urban areas and often occupy space unsuitable for residential dwelling purposes. As a result, there may be some uncertainty in determining the portion of this kind of loan which qualifies under the 72 percent standard.

The Treasury regulations under present section 7701 (a) (19) recognize this problem and provide a rather complicated rule for determining the portion of a mixed loan which qualifies for definitional purposes. Reg. §301.7701 - 13 (k) deals with amount and character of loans, and it requires a comparison based on the loan value of qualifying property to the amount of the loan involved. In the interest of easier administration of the law and better taxpayer understanding it would be appropriate to provide a statutory rule which is less complicated than the current regulations. For example, it would be simpler and more equitable to allow a loan secured in part by residential property to qualify in total if more than 50 percent of the property securing the loan is used on a space basis for residential purposes.

Another problem relating to "loans secured by an interest in real property which is... residential real property..." is whether redeemable ground rents are to be included in this category. In the state of Maryland, private homes are often sold subject to so-called ground rents under which the home buyer assumes an obligation to pay a fixed amount per year on the property and 5 years after the creation of the ground rent, he may redeem the ground rent by paying an amount computed by capitalizing the rental payment at a 6 percent rate. Mutual savings banks in Maryland purchase redeemable ground rents thereby making it possible for more individuals to afford to buy homes. These ground rents make up about 7 per cent of savings bank assets in Maryland.

The Congress recognized that redeemable ground rents are in the nature of mortgage loans when it enacted P.L. 88-9 in 1963, adding section 1055 to the Internal Revenue Code of 1954 and amending Code section 163 to provide for the deduction of annual or periodic rental payments under a redeemable ground rent as interest on an indebtedness secured by a mortgage. Moreover, the present Internal Revenue Regulations relating to both mutual savings banks and savings and loan associations define the term "loan" to include a redeemable ground rent. Reg. § 1.593-11 (a); Reg. § 301.7701-13 (j)(i). It is submitted, therefore, that section 7701 (a) (19) (C) (v) of the Code, as amended by section 442 (b) of H.R. 13270, should be changed to specifically refer to redeemable ground rents on residential property as "loans secured by an interest in residential real property."

Section 442(a) of H.R. 13270 is unrealistic and inequitable insofar as it relates to mutual savings, building or homestead associations and co-operative banks -- an alternative proposal is submitted.

Brief of the
Council of Mutual Savings Institutions*
60 East 42nd Street
New York, N.Y. 10017

1.- Section 442(a) of the bill should be withdrawn and set aside for further study and hearings -- or the alternative hereinafter proposed should be substituted.

2.- The practical effect of Section 442(a) is to nearly double the tax payments required of these mutual institutions, which they can meet only by either reducing the rate of interest-dividends paid on the accounts of their savings members, or by increasing the rate of interest charged to their borrowing members.

At the end of 1968, the average size of the approximately 5,250 mutual institutions was $23,000,000.

Based on Treasury Department figures in the Ways & Means Committee report, they paid taxes in 1966 of about $735 per million dollars.

From a random sample of 20 such institutions, we estimate that Section 442(a), when fully effective, will cost them an additional $595 per million dollars. The fact that such an increase is spread over ten years makes it no less painful than to cut off a dog's tail by inches.

Because these mutual institutions have no capital stock, but disburse all of their earnings after establishing required loss reserves, there is no source for such an increase except (a) by reducing the interest-dividends paid on accounts of savings members, or (b) by increasing the interest charged to borrowing members.

3.- The 6% ceiling in the "Reserve for Losses on Qualifying Real Property Loans" is completely unrealistic. The mutual savings banks entered the 1929-32 depression with loss reserves in the range of 12% to 14%. They came through that experience practically unscathed. The mutual savings and loan associations confronted that crisis with loss reserves that averaged no more than 5% to 6%. Their survival rate was approximately one-half, i.e., some 6,000 survived out of 12,000 or so. In 1951, when the Revenue Act of 1951 was pending, the State supervisors testified that these institutions should be permitted to accumulate aggregate loss reserves of 15%. The Congress set the figure at 12%. The ceiling decrease to 6% was effected by the 1962

* Statement of George L. Bliss, President.

amendments. In consequence, the ratio of loss reserves has been steadily decreasing, as is shown in the following table (available data includes both mutuals and non-mutuals):

Ratio of reserves, surplus and undivided profits to Resources		% decrease
End of 1941 (earliest date readily available)	7.9%	--
End of 1951 (preceding effective date of 1951 Act)	7.6%	3.8
End of 1962 (preceding effective date of 1962 Act)	7.0%	7.9
End of 1968	6.7%	4.3

(Note: See appended chart)

4.- Whereas the Internal Revenue Code provides that any taxpayer may deduct authorized losses on a direct charge-off basis or by the reserve method, all mutual institutions must use the reserve method, for these reasons:

(a) By statute or regulation, every mutual institution, without exception, must allocate a portion of earnings, before credit of interest-dividends to its savings members, to reserves for possible future losses. Following is an excerpt from a typical State law (condensed and numbering added for clarity):

> "When the net profits have been determined, if its loss reserves do not equal 10% of savings and 50% of book value of real estate held -- (1) one-twentieth of such net profit shall be credited to such loss reserve. (2) The balance, together with any amounts remaining from previous periods, shall constitute the undivided profits. The directors may transfer additional amounts to loss reserves or continue to carry as undivided profits such sum as they deem wise. (3) The undivided profits shall be available for dividends, which shall be apportioned upon the dues and dividends credited to members." (New York Banking Law, Section 387)

In addition, if its accounts are insured by the Federal Savings & Loan Insurance Corporation, it must meet the requirements of its regulations for allocations to loss reserves which, under certain circumstances, may amount to 10% of net earnings, before interest-dividends.

(b) Required to use the reserve method, by statute, regulation or the need for survival, these institutions are further confronted by a formula inconsistent with the basic principle of mutual operation, in that the Code -- since the 1962 amendments -- requires that both operating expenses and the distribution of interest-dividends be first deducted, and a tax imposed on a portion of the remainder.

(c) A further inequity exists in that the bill leaves unchanged the requirement, first imposed in the 1962 amendments, and increases the amount, of tax on amounts so set aside and available only to meet losses which are deductible under the direct charge-off basis, thereby burdening these institutions with a tax on their losses -- a condition which we do not find paralleled in the case of other taxpayers.

5.- It is not in the public interest that supervised financial institutions should be subject to inconsistent or conflicting requirements arising out of differing statutes under the jurisdiction of separate branches of government. This fact was recognized by the Congress when it passed the 1951 Act. The Congress concluded, and this was agreed to by those representing the affected institutions, that taxes should be paid on amounts carried to surplus or undivided profits, and on any allocations to loss reserves which exceed the bounds of reason. As earlier noted, the supervisory authorities recommended deductible allocations to loss reserves until they equal 15% of savings, and the Congress agreed to the principle, but established the ceiling at 12%.

(a) Much has been said about the fact that but a modest amount of taxes were collected, in consequence. The fact is, and the Congress has recognized it in its application to other mutual and coöperative organizations, that these mutual institutions do not have any "taxable income" in the ordinary sense of the word. This is demonstrated by the following table, citing typical figures of a mutual institution with, say, resources of $23,000,000:

Gross Earnings		$138,000
Less - Operating Expense		26,000
Net Income		$112,000
Less - 10% to Loss Reserves	$ 11,200	
- Interest-dividends	100,000	$111,200
Balance to Undivided Profits		$ 800 (taxable)

6.- "<u>Tax equality," which has been the loudly-proclaimed objective of the commercial bankers for so many years, is a meaningless shibboleth, unless accompanied by "investment equality</u>." For 138 years, these mutual institutions have operated to provide a specialized community service, organized not for private profit but owned by those they serve. They originated the monthly-payment, installment mortgage which has made this country a nation of home-owners. They originated installment savings plans. Today, there are 5,250 of these mutually-owned thrift and home-owning institutions, located in every State, of which some 2,000 are federally-chartered and supervised, and another 3,250 are state-chartered and supervised.

(a) The distinguished Secretary of the Treasury has recommended certain revisions in Subtitle E (comprising Sections 441, 442 and 443) of the pending bill, emphasizing the Treasury Department's objective "to create tax equity among these competing institutions." Whether the Treasury's contemplation of "tax equity" is the same as "tax equality" is not clear to us. It is our view that <u>tax equity</u> prevailed under the 1951 Act, but that it was materially upset by the 1962 amendments -- because they failed to recognize the specialized character of <u>mutual</u> thrift institutions, as distinguished from <u>privately-owned</u> financial institutions and, in the absence of capital stock on the part of the mutuals, their need for a reasonable allowable deduction for withholding a portion of earnings for possible future losses.

(b) On the other hand, if "tax equality" (in the fashion sought by the commercial bankers) is accepted by the Congress as a commendable and equitable objective, very obviously these mutual institutions should have equality of investment opportunities, in order to make available to them the more lucrative field available to the privately-owned financial institutions.

(c) The Treasury Secretary has, further, outlined a "special tax deduction" to be granted to the several types of financial institutions to encourage "the flow of credit . . . into uses determined by the Congress to be socially preferable."

It has for many years been the position of the Federal Government that the development of member-owned, mutual or co-operative organizations warrant particular encouragement by statutory enactment. Most certainly, a change in emphasis, such as the Treasury proposes, would constitute a major change in course and warrants wide-spread study and consideration before legislative action.

7.- Unfortunately, the 1951 Act, which made "domestic building and loan associations" and "cooperative banks" subject to the corporate rate of income tax, after appropriate credits to loss reserves, contained a major defect -- in that it failed to differentiate between the mutual institutions and the non-mutuals. This deficiency was perpetuated in the 1962 amendments. Accordingly, we urge these steps:

(a) That Section 442(a) be deleted from the pending bill, and

(b) As an alternative, that Sections 593 and 7701(a) be revised in a manner which (i) recognizes the distinctive character of all mutual savings institutions, (ii) accords them comparable tax status to that of other mutual or co-operative organizations, and (iii) conforms to their basic operational requirements by establishing reasonable allowable deductions for allocations to loss reserves, with ceilings of not less than 10% in the case of a "Reserve for Losses on Qualifying Real Property Loans" and of not less than 5% in the case of a "Reserve for Other Losses."

(c) A draft of amendments to the Code to implement the recommendations of the preceding paragraph is appended.

Proposed Revision of Section 7701 and Section 593 to recognize the distinctive character of mutual savings, building or homestead associations and cooperative banks, particularly with respect to their need for reasonable and adequate allowable deductions for additions to loss reserves -- and to accord them treatment comparable to that accorded to other mutual and cooperative organizations

(a) That an additional category, to be known as "domestic mutual savings institutions" be added to the Code by an appropriate amendment to subsection (a) of Section 7701, reading substantially in this manner:

"(35) DOMESTIC MUTUAL SAVINGS INSTITUTION. - The term 'domestic mutual institution' means a savings bank, cooperative bank, savings association, savings and loan association, homestead association, building association or building and loan association which is domestic, without capital stock and organized and operated for mutual purposes and without profit."

(b) That the title and subsection (a) of Section 593 be amended to read as follows (new language underlined):

"SEC. 593. RESERVE FOR LOSSES

"(a) ORGANIZATIONS TO WHICH SECTION APPLIES. - This section shall apply to any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit, except that subsection (g) and paragraph (4) of subsection (b) hereof shall apply only to a domestic mutual savings institution."

(c) That subparagraph (A) of paragraph (1) of subsection (b) of Section 593 be amended to read as follows (new language underlined):

"(A) the amount determined under section 166(c) to be a reasonable addition to the reserve for losses on nonqualifying loans, or the amount determined under subsection (g) hereof to be a reasonable addition to the reserve for other losses, plus"

(d) That subsection (b) of Section 593 be amended by designating paragraph (4) as paragraph (5), by designating paragraph (5) as paragraph (6), and by inserting new paragraph (4) to read as follows:

"(4) CALCULATION METHOD. - The amount determined under this paragraph for the taxable year shall be an amount equal to the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 10 percent of the unpaid balance of such loans."

(e) That paragraph (1) of subsection (c) of Section 593 be amended to read as follows (new language underlined):

"(1) ESTABLISHMENT OF RESERVES. - Each taxpayer described in subsection (a) which uses the reserve method of accounting for bad debts shall establish and maintain a reserve for losses on qualifying real property loans, a reserve for losses on nonqualifying loans (<u>or a reserve for other losses as provided by subsection (g) of this section</u>), and a supplemental reserve for losses on loans. For purposes of this title, such reserves shall be treated as reserves for bad debts <u>and for other losses</u>, but no deduction shall be allowed for any addition to the supplemental reserve for losses on loans."

(f) That Section 593 be amended by inserting the following new subsection (g) after subsection (f), to read as follows:

"(g) RESERVES FOR OTHER LOSSES. -

(1) In lieu of any authorized deduction for losses other than for bad debts on qualifying real property loans, a taxpayer to whom this subsection applies shall be allowed a deduction for a reasonable addition to a reserve for other losses, which shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this subsection shall not be greater than the lesser of -

(A) the amount of its taxable income for the taxable year, computed without regard to this subsection, or

(B) the amount by which 5 percent of the total of its resources, exclusive of its qualifying real property loans, at the close of such year exceeds the balance in such reserve at the beginning of the taxable year.

(2) Any reserve established pursuant to this subsection shall include the entire balance of any reserve previously established pursuant to subparagraph (A) of paragraph (1) of subsection (b) of this section."

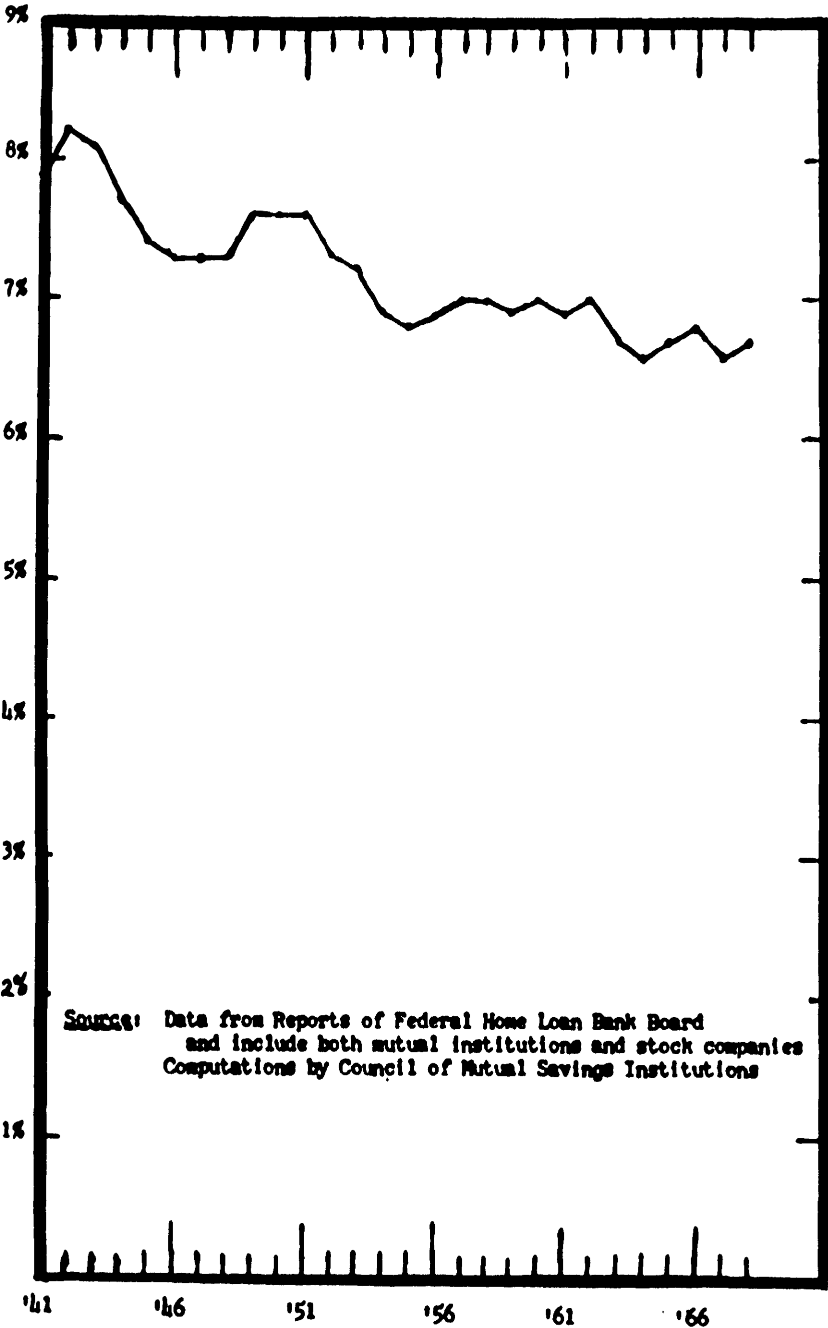
(g) Technical amendment:

Amend subparagraph (B) of paragraph (1) of subsection (b) of Section 593 by striking out "(2), (3), or (4)," and inserting in lieu thereof "(2), (3), (4), or (5),".

# # # # # #

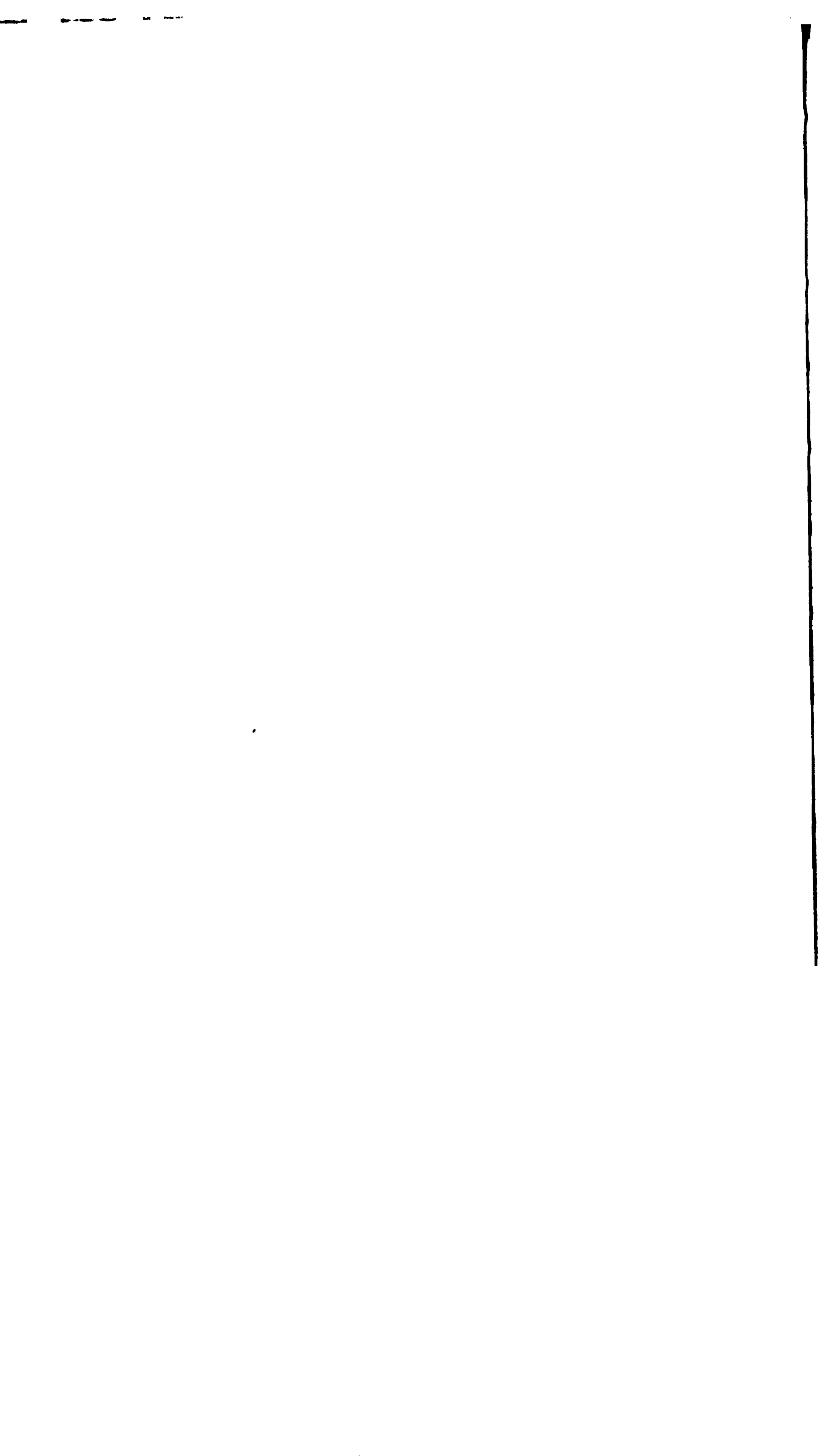
All Operating Savings and Loan
Associations and Co-Operative Banks

Ratio of Loss Reserves, Surplus and Undivided Profits
to Total Resources at Year-End
1941 -- 1968



Source: Data from Reports of Federal Home Loan Bank Board
and include both mutual institutions and stock companies
Computations by Council of Mutual Savings Institutions

33-758 O-69—No. 4—8



PRINCIPAL POINTS

Testimony of U.S. Savings and Loan League*
Re: Savings and Loan Taxation

Tax Reform Act of 1969 (See Accompanying "Full Statement")

(1) The League is opposed to any change in the fundamental tax provisions (60-40 formula). This formula has produced the anticipated tax revenues and has enabled savings and loan associations to perform their vital function of residential financing. Any basic change would be detrimental to the savings and loan business and to the housing market. A tax increase would add to mortgage costs, reduce ability to attract savings and impair reserve position and future growth. The business accepts the elimination of the 3 percent alternative and the special treatment on bond sales and these are the only true "reforms" dealing with savings and loan associations.

(2) Provisions in the House-passed bill and the Treasury proposals go beyond tax reform and loophole closing and affect the basic nature of our financial institutions and the mechanism of financing American homes.

(3) The proposed increased taxes would impair the mortgage lending ability of the Nation's largest home lenders. This would occur at a time when housing starts are declining, mortgage rates are soaring and other lenders (such as life insurance companies and commercial banks) have pulled out of residential lending, particularly single-home financing.

(4) The pending proposals "equalize" taxes on thrift institutions as compared to commercial banks which is contrary to historic inducement for thrift institutions to invest in mortgages.

(5) The impact on savings and loan associations is much heavier than on commercial banks, as shown by the following brief table:

* Presented by C. R. Mitchell, Legislative Chairman.

		S&Ls	Comm. Banks
"Proposed" Effective Rate		30%	30%
Previous Effective Rate	1960	1%	38%
	1963	16%	31%
	1966	17%	23%

(6) Savings associations are by law and tradition locked into long-term residential financing and do not have the diversified higher profit operations as commercial banks. Savings and loan associations cannot take advantage of rapid increases in interest rates.

(7) The importance of sustaining the savings and loan business at this time is reflected in: (a) Senate Subcommittee on Financial Institutions' current hearings to provide Treasury advances to the Federal Home Loan Bank System, and (b) expressions from the Secretary of Housing, the Chairman of the House Banking Committee, the Chairman of the House Housing Subcommittee, the Federal Home Loan Bank Board, homebuilders and other officials of the housing industry.

(8) The alternative Treasury proposal as presented September 4 would not lessen the effect of the changes provided in H. R. 13270. Both seem to have about the same practical effect except that the Treasury proposal will get us to the point of double taxation faster. The Treasury proposes a five-year phase-in -- the House bill provides for a ten-year phase-in. Both proposals would equalize the effective tax rate for savings and loan associations and for commercial banks. Treasury spokesmen at the opening of these hearings told this Committee that the Treasury's objective is to tax both institutions at an effective rate of approximately 30 percent.

FULL STATEMENT

STATEMENT OF

UNITED STATES SAVINGS AND LOAN LEAGUE*

BEFORE THE

SENATE FINANCE COMMITTEE

ON THE

TAX REFORM ACT OF 1969

Re: Taxation of Savings and Loan Associations,
Financial Institutions, etc.

September 15, 1969

Presented by C. R. Mitchell, Legislative Chairman
Accompanied by Norman Strunk, Executive Vice President
Stephen Slipher, Legislative Director

Our principal concern with respect to the provisions of the Tax Reform Act, as approved by the House of Representatives last month, as well as the Treasury Department proposal for revising savings and loan taxation as presented by Treasury spokesmen to this Committee at the outset of these hearings, is that they go far beyond tax reform and the closing of tax loopholes. Both the House bill provisions and the Treasury recommendations for savings and loan taxation relate to a much more fundamental question, and that is the nature of the financial institutions in this country and how homes should be built and financed. Stated succinctly, we believe that the provisions of the House bill and the Treasury proposals for savings and loan taxation will ultimately mean the stagnation of the savings and loan business as we know it today. The effect would be to eliminate this assured source of home mort-

---

* The United States Savings and Loan League has a membership of 5,000 savings and loan associations representing over 95% of the assets of the savings and loan business. League membership includes all types of associations - Federal and state chartered, Federally insured, uninsured, stock and mutual. The principal officers are: Tom B. Scott, Jr., President, Jackson, Mississippi; John H. Randolph, Jr., Vice President, Richmond, Virginia; C. R. Mitchell, Legislative Chairman, Kansas City, Missouri; Norman Strunk, Executive Vice President, Chicago, Illinois; and Stephen Slipher, Legislative Director, Washington, D. C. League headquarters is at 221 North LaSalle Street, Chicago, Illinois; and the Washington Office is maintained at 425 - 13th Street, N. W., Washington, D. C. - Telephone: 638-6334.

gage credit and eventually require a much larger role for the Federal Government in the financing of homes for the American families.

This is a bold and sweeping statement. I propose to document it for you in my time before the Committee this morning.

A very brief history should be helpful. Savings and loan associations were developed in this country in the 1800's by the state legislatures in order that families might have a place to go for credit to buy a home where they did not have to compete for credit with all types of other borrowers. Lawmakers recognized from the beginning that a typical family cannot compete on even terms for credit -- especially long-term credit of the type needed for home purchases -- with commercial enterprises, large corporations, well-to-do families and with Governments, and that a special type of institution had to be created in order that the home ownership ambitions of the American families could be realized.

With the collapse of the financial system in the 1930's, the United States Congress supplemented the actions of the state legislatures and created a system of Federally chartered savings and loan associations, the Federal Home Loan Bank System and the Federal Savings and Loan Insurance Corporation. The Congress took these steps to assure itself that the family seeking credit for the purchase of a home would come before other types of borrowers and where the typical family would not get shoved aside in favor of someone bigger or more able to pay a higher rate of interest.

Since the first Federal income tax law, Congress has provided some tax incentives to savings and loan associations. Originally, these institutions were completely exempt from Federal income tax so long as they confined their business to accepting savings and investing these savings in home loans. This tax exemption was repealed in 1951, but the bad debt allowance provided resulted in only nominal tax payments, until the Revenue Act of 1962. In that Act, Congress carefully provided for a different bad debt allowance than that given commercial

banks and rather deliberately structured the law so savings and loan associations would pay Federal taxes at about half the rate of that paid by commercial banks. In the early 1960's, commercial banks were paying an average rate of tax of about 35 percent of so-called economic income. Beginning in 1963, savings and loan associations paid taxes at an effective rate of about 16 percent. The exact figures follow:

Tax as Percent of "Economic Income" *

Year	Commercial Banks	Savings and Loan Associations
1960	37.8%	1.0%
1961	35.6	0.8
1962	33.3	0.9
1963	30.6	16.0
1964	28.2	14.8
1965	23.3	15.2.
1966	23.2	16.9

*Source: Tax Reform Studies, U. S. Treasury, February 5, 1969

Most associations pay taxes under the so-called 60-40 formula provided in the 1962 Act. This provides simply that associations may set aside 60 percent of their income after expenses and interest payments to the depositors into reserves and pay taxes on 40 percent of their net income. The 1962 Act also provided a so-called 3 percent of loan growth alternative method of computing allowable additions to the reserve for bad debts.

This 3 percent of loan growth formula has been used by some savings and loan associations and most mutual savings banks. It had the unpredicted results of making it possible for institutions with rapid increases in their mortgage loan portfolio to escape Federal income taxes almost completely. This turned out to be a real loophole in the savings and loan and savings bank section of the 1962 Revenue Act. We have no objection to this loophole being closed. We consider closing it a legitimate part of tax reform.

Neither do we have any objection to the changes proposed in the House bill relating to the tax treatment of capital gains and losses in connection with trans-

actions in Government securities. This change has been discussed in connection with changes in the taxation of commercial banks. It also applies to our institutions, and we have no objection to this method of tax reduction being eliminated, nor do we have objections to other detailed changes proposed in the House bill relating to types of income to be included in computing taxable income. These changes constitute tax reform, and we think they are appropriate in the context of this bill.

However, the heart of our position is our vigorous objection to the radical proposed revision in the 60-40 formula. This provision in the House bill would mean a virtual doubling of savings and loan taxation over a ten year phase-in period. It seems to us this is much more drastic than loophole closing or tax reform.

The alternative Treasury proposal presented September 4 would not lessen the effect of the changes provided in H. R. 13270. Both seem to have about the same practical effect except that the Treasury proposal will get us to the point of double taxation faster. The Treasury proposes a five-year phase-in -- the House bill provides for a ten-year phase-in. Both proposals would equalize the effective tax rate for savings and loan associations and for commercial banks. Treasury spokesmen told this Committee that the Treasury's objective is to tax both institutions at an effective rate of approximately 30 percent.

The Congress fortunately has always seen fit to preserve a tax rate differential between those financial institutions whose primary purpose is to assure the American family of a source of home mortgage credit and the multi-purpose, full-service type of financial institutions. This policy of differential was adhered to in the House debate even though last minute changes with respect to commercial banks did, in fact, eliminate the differential according to our statistics.

History has demonstrated that those institutions with a broad range of lending alternatives cannot be expected to be a dependable source of credit for home ownership. Home ownership credit is a specialized credit and there are many periods when lending for home building and home buying is not as profitable as

other types of lending or investing. That is why the Congress created a new system of savings and loan associations in the 1930's and that is why they created a special Federal Savings and Loan Insurance Corporation -- independent and separate from the Federal Deposit Insurance Corporation which was created to insure deposits in commercial banks, and that is why Congress created a central banking system -- the Federal Home Loan Bank System -- separate from and independent from the Federal Reserve System. That is why the Congress put the agencies relating to the savings and loan business under an independent Board responsible separately to the President and the Congress -- the Federal Home Loan Bank Board. That is why the Congress has always given savings and loan associations a tax incentive.

The continuous Congressional concern with housing is evidenced in many ways. The Congress has provided and has repeatedly expanded Federal programs relating to Urban Renewal, public housing, subsidized home loans, subsidized rental loans and the purchase of hundreds of millions of dollars by the Federal National Mortgage Association. Without exception, those in the Federal Government and in the Congress with special housing responsibilities have expressed grave concern over the present housing market conditions. Just last week a Senate Subcommittee held hearings on proposals to provide direct Treasury support to the housing market. Legislation has been introduced to provide for $10 billion of direct Federal loans to middle-income families. An almost endless list of actions and statements by public and private officials could be presented with respect to the importance of our national housing programs.

Dr. Irwin Friend of the Wharton School of Finance at the University of Pennsylvania has just completed a three-year study of the savings and loan business, a study that was commissioned by the Congress. Dr. Friend's report, released last week, points out that "savings and loan associations have the most specialized asset structure and the greatest imbalance between the maturity structure of assets (mainly long-term residential mortgages) and liabilities

(largely short-term deposits) of any major group of financial intermediaries."

The industry's role in the economy, he noted, has been to accumulate funds from individual savers and make these funds available for financing housing, thus lowering the cost of investment in housing and providing savers with a higher return or lower risk.

"To help the associations carry out these functions--especially the stimulation of investment in housing," Professor Friend said, "they have received several forms of Government assistance, most notably a favorable tax treatment which was intended, at least in part, to compensate them for the lack of investment flexibility resulting from their commitment to the residential mortgage market."

The basic question that Professor Friend raised is whether these present forms of assistance are adequate to insure the viability of the industry in the future, especially during periods of tight money.

Dr. Friend's report pointed up the fact that the savings and loan business is today having great problems in adjusting to the effects of inflation and much higher interest rates. Certainly, this is no time to eliminate or even to phase-out such special protections as the present bad debt allowance which serves in part to alleviate the severe operating problems that tight money has brought to our institutions and to the housing market.

Housing starts currently are in a precipitous decline. Between January and July of this year housing starts have fallen from a seasonal adjusted rate of 1.9 million to 1.3 million -- or 28.9%, and projections indicate the decline could continue to a million or less units. It is well recognized that home financing institutions are feeling the burden of tight money more heavily than commercial banks which, by the nature of their operation, are more readily able to adjust to rapid increases in interest rates. It is well recognized that housing and home building are this year -- as in 1966 -- bearing a great and disproportionate share of the cost of the economic effects of tight money. In fact, the home building

industry thus far is about the only major industry in the American economy that has been curtailed by the fiscal and monetary restraints that are currently imposed on the economy. This is due in great part to the fact that the growth rate of the savings and loan business has been declining for several years -- particularly in 1966 and again this year.

It should be noted that even relatively small differences in the rate of growth in the savings and loan business, whether caused by adverse taxation or economic or competitive conditions, has a tremendous impact on housing. The Federal Home Loan Bank Board has estimated that a billion dollar change in savings affects 21,500 housing starts in the initial year, and 80,000 housing starts over the long run. In a business the size of the savings and loan business -- over $150 billion -- it is quite possible to have variations in growth patterns of $5 billion or more in a year. Obviously, the difference in good and bad growth for the savings and loan business translates into hundreds of thousands of housing starts initially, and increases to millions of houses over a period of years.

In its tentative decisions, the Ways and Means Committee indicated that a differential in the effective rate of tax between the savings and loan associations and commercial banks was to be preserved. Committee sources indicated that commercial banks were to be taxed at an effective rate of 36 percent and savings and loan institutions at an effective rate of 30 percent. Our business did not feel that this was enough of a differential in the effective tax rate, but at least there was recognition by the Ways and Means Committee that there should be a differential in the tax rate of the commercial banks and the savings and loan associations, and that there had to be some incentive for our institutions to continue to function as a special service institution for home financing.

Because of a last-minute change in its treatment of tax exempt interest by financial institutions, however, the final tax bill passed by the House would equalize the tax rate between commercial banks and savings and loan associations,

which, as the Treasury spokesmen say, is the objective of the Treasury Department. Our data based on the 1968 operations show we would pay, on the average, an effective tax rate of approximately 34 percent compared to 19 percent under the present law. This would be true under both the House bill and the Treasury proposal. Unless the commercial banks change their asset mix considerably, we doubt that their effective tax rate would be that high. Both the Treasury and the FDIC estimate the effective rate for the commercial banks to be 30 percent.

Several fundamental questions present themselves. First, is it proper and sound public policy to tax such different types of financial institutions as banks and savings and loan associations alike? (Remembering that a tax differential has been public policy from the very beginning.) Second, what will be the eventual result of equality of taxation of these institutions?

We are not dealing here with ordinary business enterprises that can do virtually anything their management chooses, that can diversify their operations, drop unprofitable lines, merge, expand to new markets and new cities, etc. We are dealing here with financial institutions chartered either by Federal or state governments able to do only those limited things which the lawmakers, primarily the members of the United States Congress, rigidly prescribe. Savings and loan associations cannot go out and broaden their scope of operation, add profitable new lines, move into new markets in distant cities and compete on equal terms with multi-purpose, full-service commercial banks. The laws prevent this type of competitive equality.

While the advocates of equal taxation give lip service to companion equality among thrift institutions with respect to investment and operating powers, this is totally unrealistic. The modest changes suggested by the savings and loan advocates have never encroached on the fundamental commercial bank prerogatives such as demand deposits, creation of money and general business banking. More importantly, we doubt the Congress would want to see any fundamental change in the nature and structure of savings and loan associations. The history of Congressional action

over the last twelve to fifteen years makes it quite clear that the Congress wants to keep the savings and loan business narrowly confined to the business of financing shelter for the American people, primarily single-family home ownership. Congress should recognize that as a quid pro quo for our institutions remaining home financing specialists, there should be a considerable difference in the tax treatment of our institutions and the commercial banks.

Of course, the application of equal taxation will have the effect of driving thrift institutions away from housing in an effort to obtain the profitability which enables commercial banks to prosper irrespective of taxation. Either this will happen or these institutions will lose their competitive capability and cease to be the effective force in home financing that they need to be if our home ownership and home financing system in this country is to be preserved.

The following table shows the importance of savings and loan associations and mutual savings banks in home financing.

TOTAL RESIDENTIAL MORTGAGE LOANS OUTSTANDING
(Dollars in Billions)

	December 31				
	1964	1965	1966	1967	1968
Savings & Loan Assns.	$ 94.2	$102.3	$106.0	$112.9	$120.7
Mutual Savings Banks	36.5	40.1	42.2	44.6	46.7
Life Insurance Companies	35.8	38.4	40.6	41.6	42.4
Commercial Banks	28.9	32.4	34.9	37.6	41.4
All Other Holders	35.7	36.9	40.1	43.1	47.3
TOTAL	$231.1	$250.1	$263.8	$279.8	$298.5

PERCENT HELD BY SAVINGS INSTITUTIONS

	1964	1965	1966	1967	1968
Savings & Loan Assns.	40.8%	40.9%	40.2%	40.4%	40.4%
Mutual Savings Banks	15.8	16.0	16.0	15.9	15.6
TOTAL	56.6%	56.9%	56.2%	56.3%	56.0%

Sources: Federal Home Loan Bank Board; Federal Reserve Board

These data relate to total mortgage loans including loans on multi-family properties. So far as the market for credit for one-to-four family homes is concerned, the market is especially dependent on savings and loan associations and savings banks. In recent years, life insurance companies have moved out of financing one-to-four

family dwellings to multi-family and commercial real estate. Commercial banks are much less significant in financing residential real estate. Traditionally, and especially so in periods of tight money, the commercial bank's role in mortgage lending is essentially that of a construction lender or one providing the so-called interim financing with the take-out or permanent loan made by life insurance companies, savings banks or savings and loan associations. In times like these, commercial banks are not significant as permanent investors in mortgages or large portfolio lenders and, incidentally, the Treasury proposal will not change this. Commercial banks do not carry the interest rate risk. They don't get stuck with a portfolio of long-term mortgage loans written at interest rates much lower than rates are today. It is the savings and loan associations and the mutual savings banks that carry the risk of rising interest rates and thus have their earnings squeezed and their competitive abilities severely limited in periods like 1966 and 1969.

The following table shows the share of savings and time deposits allocated by various financial institutions to residential mortgage loans.

THE SHARE OF SAVINGS AND TIME DEPOSITS ALLOCATED BY FINANCIAL INSTITUTIONS TO RESIDENTIAL MORTGAGE LOANS

Dec. 31	Savings Associations	Mutual Savings Banks	Commercial Banks (1)	Life Insurance Companies (2)
1964	92.4%	74.7%	24.8%	23.9%
1965	92.7	76.5	24.1	24.2
1966	93.0	76.8	23.9	24 3
1967	90.6	74.3	22.4	23.5
1968	91.7	72.5	22.4	22.6

Source: Federal Reserve Board

(1) Residential mortgage loans as a percent ot total savings and time deposits of individuals, partnerships and corporations.
(2) Residential mortgage loans as a percent of total assets.

In recent years, the savings and loan business has secured a decreasing share of total family or household savings. It is well known that the savings and loan business currently is in trouble competitively and the mortgage market has suffered

as a result.

The savings and loan business must earn enough to be able to pay enough to be able to attract savings. Associations compete for savings with the commercial banks, with mutual funds and with the securities market, primarily the short-term securities issued by the United States Treasury and the various Federal Agencies. Its competitive edge over the commercial banks is protected by Regulation Q, but this is a very slight edge. The policy people in the Administration constantly suggest that the protection of Regulation Q as to the flows of funds into savings and loan associations and mortgages is not to be expected as a long time proposition. Savings and loan associations need to pay higher rates for savings, but, we cannot raise our rates on existing loans, and there are ceilings on mortgage loan interest rates in many states. We do not like to constantly raise the rates we charge home buyers and there are real limits on how much families can pay for money and afford home ownership.

We have the problem of earning enough to be competitive and we do not know how we can be competitive in attracting savings if our income tax is, over a phase-in period, virtually to double. At the present time, our mortgage portfolio (heavily weighted with previously made low-rate mortgages) earns an average of about 6 percent. We currently pay our savers an average of about 5 percent. This leaves just a one percent spread which must cover all operating expenses, allocations to reserves, and local, state and Federal taxes. This is obviously a far cry from the status of commercial banks. Their prime lending rate is currently 8-1/2 percent, and they pay interest on only about one-half of their total deposits. We cannot offer the broad range of services in competing for savings deposits with full-service commercial banks. We have no new ways of earning more money to pay higher taxes. We cannot go into new making-money ventures as can commercial banks or other lines of business.

Ours is a very specialized business because Congress wants us to do essentially one thing, and we do not think we will be able to continue to do that one thing if the tax picture is radically changed as proposed by the House bill or by the Treasury.

Thus, we have at stake in this legislation not just tax reform and loophole closing, but the fundamental question of whether Congress is to preserve a system of home financing institutions and to protect a source of mortgage money for the average American family -- the same family that this tax bill is designed to help.

It should be noted that there are presently two types of organizations engaging to some extent in residential financing who are granted full tax exemption. The first consists of pension and retirement funds which are granted full tax exemption; the second are the mortgage investment trusts which pass through substantially all of their income and by reason thereof are exempt from taxation. Neither of these two establishes or maintains reserves to enable them to survive the impact of a substantial downturn of business. If the time ever comes when a substantial downturn occurs, those two types of businesses will be out of the mortgage market. They will also be out of the mortgage market if other types of investments are more attractive, including mortgage lending on commercial and industrial properties. They are not limited to residential financing.

Savings and loan associations are required by regulatory authority to maintain substantial reserves and to continue to add to those reserves annually. These reserves will permit them to carry on through recessions of all kinds, and to continue in the limited field of residential mortgage lending. Ways must be found for this industry to continue to grow. The job of getting this industry to again grow and expand will be made much more difficult, if not impossible, by adding a greater tax burden at this time.

Public policy in this country from its early years has encouraged the ownership of homes and farms by ordinary families. The veterans of the Civil War were offered 40 acres and a mule. After World War II, a grateful Congress provided the

GI loan program. The United States has developed in great part as it has because of the deliberate policy of encouraging the purchase of land and homes by the ordinary family which distinguishes this country from most others of the world. The savings and loan business has been a key part of that program. We believe that the policy of Congress with respect to taxation of thrift institutions should be to continue to encourage home ownership and to avoid the creation of substantial barriers to American families who need to borrow money at reasonable rates in order to buy a home.

33-758 O-69—No. 4—9

4. The savings and loan association is unique, being distinguishable from other corporations in the several respects listed in the statement of testimony.

5. The savings and loan industry needs funds readily available in bad debt reserve more than ever during this period when the inflationary effects on housing are more severe than in the rest of the inflated economy.

6. Adequate bad debt reserves must be built up gradually; they cannot be gathered overnight.

7. Surely this is not the time to diminish the ability of the savings and loan industry to accumulate substantial bad debt reserves as quickly as feasible.

8. The 10-year carryback and 5-year carryforward provision for net operating losses is not an adequate alternative to a bad debt reserve; it produces no ready cash to meet current expenses confronting an association suffering losses.

9. The savings and loan industry consistently supplies a major portion of residential finance in the United States.

10. The savings and loan industry is still funding home finance from diminishing savings funds and other resources.

11. The current rate of residential construction - 1.3 million units a year - is far short of the 1968 statutory goal of 26 million units in 10 years.

12. Savings and loan associations acquire savings and borrowed funds on a short-term basis, but invest in long-term mortgages.

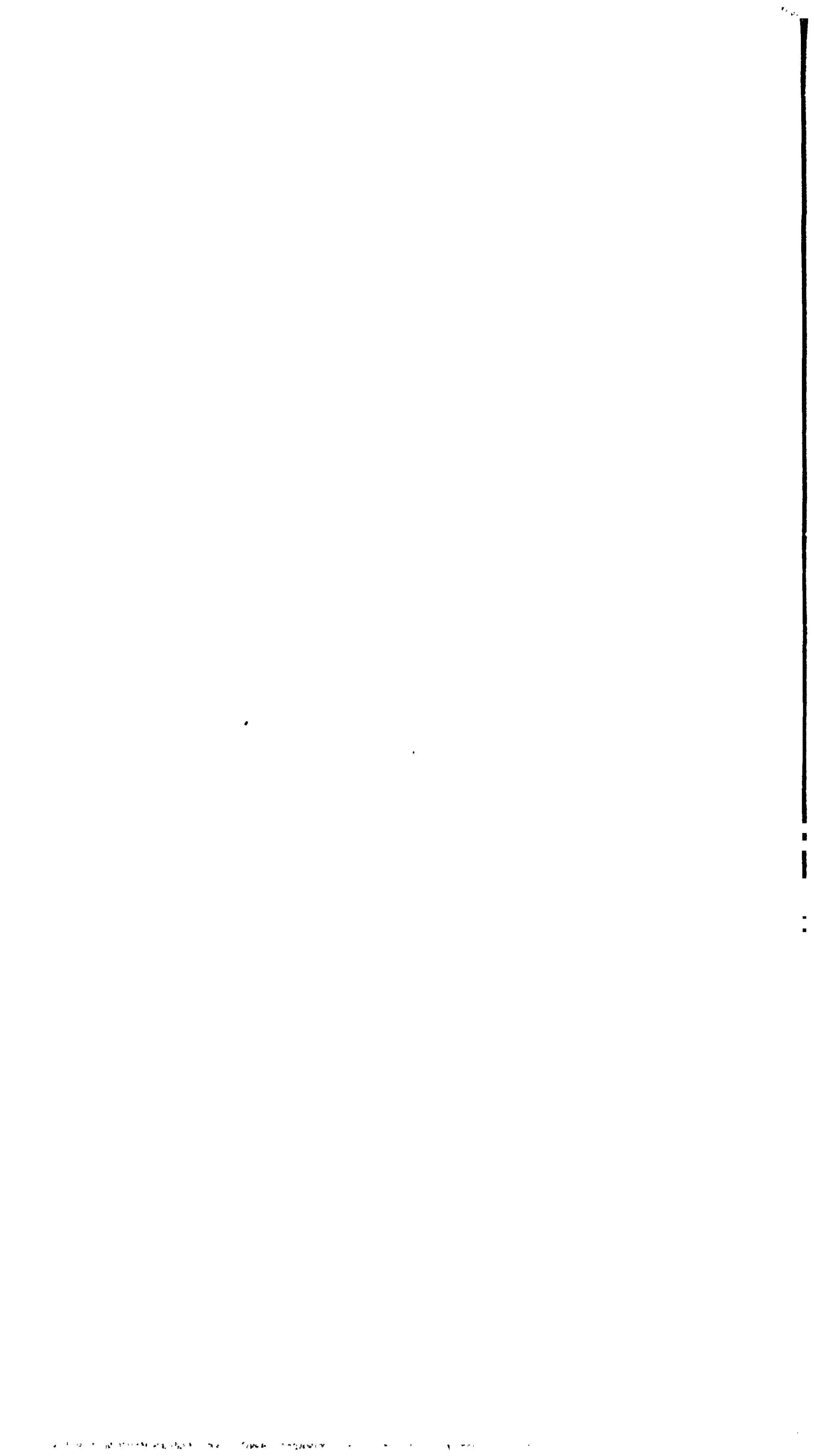
13. Consequently they must pay current market rates for working capital but obtain only unvariable fixed-rate returns on mortgage investments in their portfolios, making yields lag behind current interest rates in times of high interest levels.

14. H. R. 13270 would almost double savings and loan Federal income taxes in 10 years, by cutting the 60% maximum in the taxable income bad debt reserve formula to 30% over a 10-year period.

15. Lacking details as to the phase-in provisions of the Kennedy-Cohen special deduction proposal, it cannot be supported by the National League if it involves an immediate minimum base of 60% of taxable income.

CONCLUSION

A. Additional taxes resulting from the bill's reduction of the 60% maximum for the present taxable income bad debt reserve formula



Summary of Principal Points*

in

National League of Insured Savings Associations

Testimony

to

Senate Committee on Finance

on

H. R. 13270

September 15, 1969

1. The savings and loan industry has been paying the amount of taxes anticipated by the Treasury Department under the bad debt reserve formulas in the Revenue Act of 1962.

2. Savings and loan associations are subject to the same Federal income tax rates as other corporations. Only the bad debt reserve allowance differs.

3. The history of the 1930's and recent experience show that savings and loan associations need higher bad debt reserves than other corporations.

*Presented by William J. McKeever, Past President.

to 30% over 10 years would absorb a significant amount of new funds that could otherwise go to the home mortgage market.

B. They also would inhibit the ability of savings and loan associations to build adequate bad debt reserves to offset long-term mortgage risks.

C. The National League therefore strongly urges retention of the 60% maximum in the taxable income formula for computing bad debt reserves for savings and loan associations.

STATEMENT

of

National League of Insured Savings Associations

before the

Senate Committee on Finance

on

H. R. 13270

September 15, 1969

Mr. Chairman and members of the Committee, my name is William J. McKeever. I am President of Public Federal Savings and Loan Association of Philadelphia, Pennsylvania and Immediate Past President of the National League of Insured Savings Associations. The National League appreciates the opportunity to present to you its views on H. R. 13270, the Tax Reform Act of 1969.

It was in 1962 that the Congress enacted three alternative bad debt reserve formulas under which the savings and loan industry has operated since that time. In its report on H. R. 13270, the House Committee on Ways and Means acknowledge that "about 90 percent of the savings and loan associations use the 60-percent method and are currently paying taxes in the manner generally anticipated under the tax formula

adopted in 1962." (House Report No. 91-413 (Part I), August 2, 1969)

Savings and loan associations are in material part subject to the same provisions and Federal income tax rates as other corporations. The only substantial difference being that in computing taxable income to which the regular tax rates apply, a more favorable bad debt reserve allowance is permitted in recognition of the risks involved in long-term mortgages that constitute most of the investment portfolio of savings and loan associations.

Because as a matter of law and practice, savings and loan associations invest most of their funds in long-term real estate mortgages, they absolutely require a higher bad debt reserve than other corporations. The numerous failures that occurred in the industry in the Great Depression of the early 1930's bear stark witness to the fact that although the homes that served as security for mortgages were sound, the financial inability of mortgagors to make payments on the mortgage when due burdened the savings and loan industry with losses beyond the capability of their then bad debt reserves to meet.

The importance of maintaining adequate bad debt reserves is still paramount despite the introduction of the monthly payment type of mortgage generally prevalent today. It is not necessary to go outside the District of Columbia to find a recent example of a savings and loan association that found it necessary to merge with another because the merging association's bad debt reserves were inadequate.

Unfortunately, the report of the House Committee on Ways and Means on H. R. 13270 does not give sufficient recognition to this imperative need for bad debt reserves due to the nature of the savings and loan association. That Committee Report cites as the Committee's reason for concluding that present bad debt reserve provisions applicable to mutual thrift institutions are "unduly generous", the fact that they have allowed these institutions "to pay a much lower average effective rate of tax than the average effective rate for all corporations." (House Report No. 91-413 (Part I), page 125) Accordingly, the report continues, H. R. 13270 amends the special bad debt reserve provisions of existing law applicable to those institutions to provide assurance that significant tax will be paid in most cases on their retained earnings.

We fear that this line of argument in the report fails to recognize the enormous difference that exists between savings and loan associations and other types of corporations, despite the Committee's sincere conclusion that the changes wrought by the bill in such bad debt reserve provisions would still result in reserves consistent with the proper protection of the thrift institution.

The savings and loan association:

1. Pays out about 90 per cent of its net income as interest on deposits to its savers (a pattern that would exempt a real estate investment trust from Federal income tax).

2. Invests almost 100 per cent of its savings account funds in real estate mortgages.
3. Invests most of its assets in mortgages having maturities in the range of 25 to 35 years.
4. From a practical standpoint must be ready to meet withdrawal demands as they are made.
5. Borrows short and lends long.
6. Assumes the unknown risks that can arise over a quarter century on nearly all its loan portfolio.
7. Is expected to and does finance residential construction and transfer consistently in good times and in bad.

Savings and loan associations are unique in being corporations that possess all of the foregoing seven attributes. Consequently they need and deserve tax treatment substantially different from that accorded other corporations.

Particularly during the current period of inflationary pressures, savings and loan associations need adequate bad debt reserve funds available. In the field of housing that provides security for nearly all mortgages held by such associations, the inflationary pressures are even more severe than in the rest of the national economy.

Material assembled by E. H. Boeckh and associates demonstrates that compared with a 1957-9 base equaling 100, the construction cost

index for residences was 111.6 in 1964 and 143.2 in January 1969, constituting a 28 per cent increase.

Secretary of Housing and Urban Development Romney recently testified to the Subcommittee on Housing of the Senate Committee on Banking and Currency that the cost of housing is rising at the rate of 1 per cent a month or 12 per cent a year.

Practically every cost element entering into the construction of residences from the cost of land through the cost of labor and materials is rising sharply.

The comparative size of loss on a loan in default or a foreclosed property is likewise rising. For not only are the amounts of periodic payments due on the mortgage loan higher but so are the costs of maintaining property taken over by the association due to default under the mortgage during the period when the property is an expense rather than an income-producer for the association. Meanwhile the association must continue to pay dividends or interest to the saver on the accounts that produced the funds to make the mortgage loans. Associations must have bad debt reserves on hand and available to take care of these losses in order to continue normal operations. We wish to stress that the reserve funds must be available for use when needed. They must be accumulated in good times for use in bad times. They cannot be built to sufficient levels overnight.

During this period when the degree of inflation in housing surpasses general inflation, it is vitally important that more funds be available in bad debt reserves. Surely it is not a period in which the ability of associations to build substantial reserves as quickly as feasible should be diminished in the manner proposed in H. R. 13270. Each dollar taken for additional taxes diminishes the amount available for addition to reserves or for investment in home finance.

Nor is the bill's proposal for a 10-year carryback and 5-year carryforward for losses an adequate alternative. First, we question whether this provision would achieve its intended goal since bad debts would be chargeable against the association's reserves and, second, we would doubt whether the provision would produce funds in time to meet current expenses of an association that is suffering losses due to defaulted or foreclosed mortgages.

Under the existing bad debt reserve formulas the savings and loan industry has consistently supplied a major portion of the residential finance in this country. Almost half the homeowners in the nation have reached that status with the aid of mortgage loans from savings and loan associations. The 90th Congress in the Housing and Urban Development Act of 1968 set a housing goal of 26 million units over a 10-year period. Savings and loan associations have combined a dwindling supply of savings funds with proceeds of repayments on outstanding mortgage loans and borrowings from the Federal

Home Loan Bank System and other sources to furnish a substantial percentage of the mortgage financing for the housing now being built at the rate of only 1.3 million units per year, which is far below the rate needed to meet Congressional housing goals.

Savings and loan associations by their nature borrow and acquire savings funds on a short-term basis and lend in the real estate mortgage market on a long-term basis. This results in a need for meeting current market costs of money to attract short-term savings while being frozen into fixed-rate yields on long-term mortgage investments. From 1963 through 1967 attracting savings funds has required the payment of dividends thereon in an increasing range of more than 6 1/2 percentage points from 62.6 per cent to 69.2 per cent of gross operating income. The long-term nature of mortgages held in portfolio reduces the average yield far below current mortgage yield for new loans in a high interest rate period. Real estate mortgage interest income ranged from 84.7 per cent to 87.6 per cent of gross operating income from 1963 through 1966, decreasing to 86.2 per cent in 1967, representing a maximum range of less than 3 percentage points. Net operating income after payment of dividends in the savings and loan industry decreased from 13.7 per cent to 8.9 per cent of gross operating income over the period from 1963 to 1967. Contrary to some apparent opinion, the industry does not lay golden eggs in the form of profits.

In the face of efforts of savings and loan associations to continue to supply mortgage credit to a needy housing market, section 442 of H. R. 13270 would almost double the Federal income tax bill for the savings and loan industry at the end of 10 years. This would result from the provision in section 593(b)(2) of the Internal Revenue Code of 1954 as it would be amended by H. R. 13270 that reduces the 60 per cent maximum for the taxable income formula for computing a bad debt reserve to a 30 per cent maximum over a period of 10 years at the rate of 3 percentage points a year.

We believe the industry can live with the several other changes made by H. R. 13270 in bad debt reserve formulas for savings and loan associations.

In their recent testimony to your Committee Secretary Kennedy and Assistant Secretary Cohen set forth the general outline of some proposal that would provide a special tax deduction for financial institutions, including savings and loan associations. Their statement indicated that details would be provided in a later memorandum to your Committee. Lacking knowledge of those details, particularly those dealing with a phase-in period, it is difficult to appraise the effect of the proposal. However, the testimony disclosed sufficient information to indicate that, if the 60 per cent minimum taxable income requirement therein mentioned would become immediately effective, the proposal would result in immediate and substantial increases

in Federal income taxes from savings and loan associations as compared with either the present law or the requirements of H. R. 13270 during the next few years. If this be true, the proposal cannot be supported by the National League for the same reasons it cannot support the reduction H. R. 13270 would cause in the 60 per cent maximum in the taxable income bad debt reserve formula.

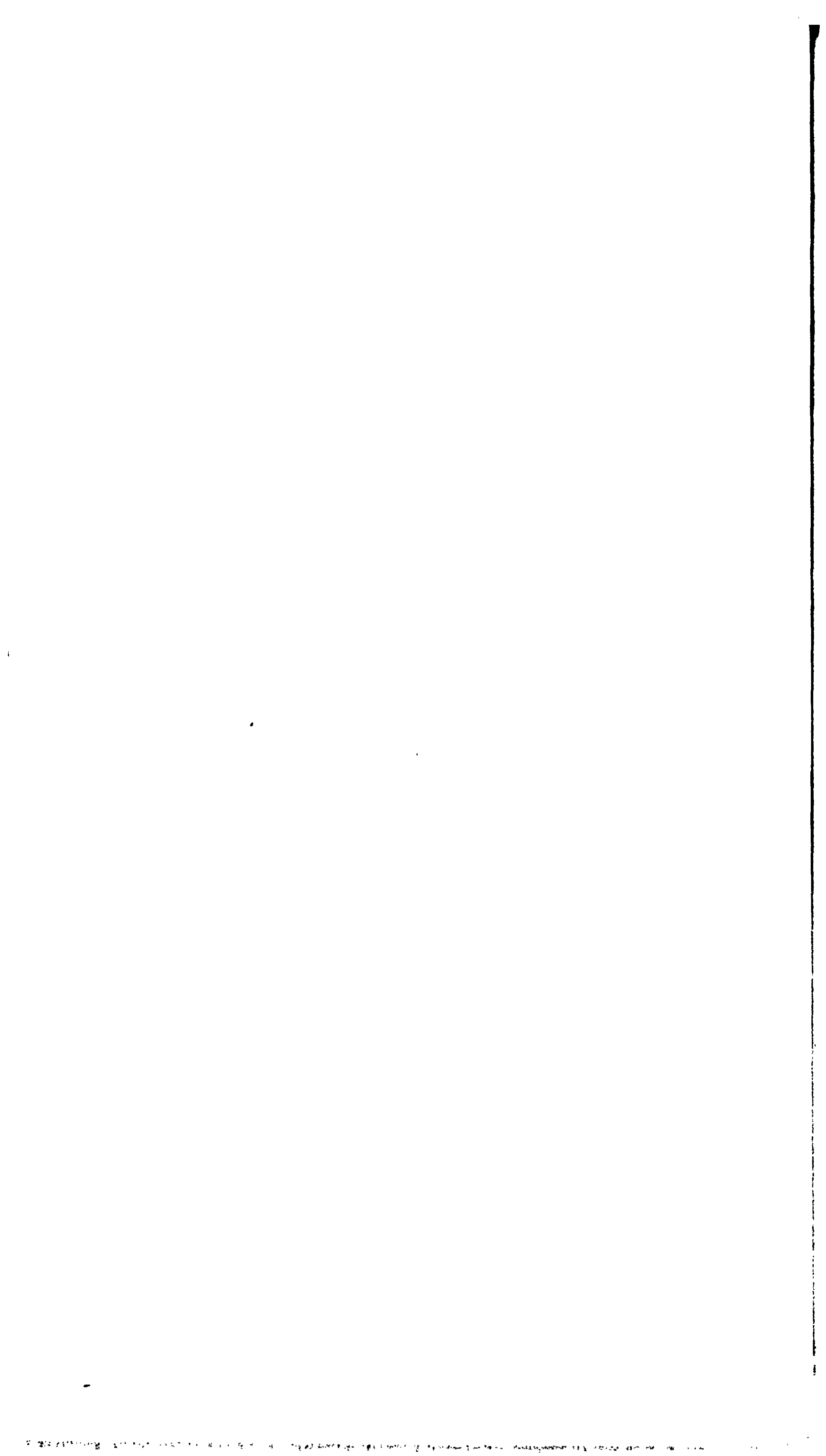
In summary:

(1) The reduction of the 60 per cent maximum to 30 per cent would absorb in taxes a significant amount of new funds from the home mortgage market.

(2) Long-term mortgages involve a degree of risk demanding adequate bad debt reserves. The increased tax requirements resulting from H. R. 13270 will inhibit the ability of savings and loan associations to build such reserves.

The National League strongly urges this Committee to retain the present provision in section 593(b)(2) of the Internal Revenue Code of 1954 that fixes at 60 per cent the maximum for the taxable income formula usable in determining a bad debt reserve for savings and loan associations.

We appreciate the opportunity of presenting these views.



SUMMARY OF POSITION ON TAX REFORM LEGISLATION

CALIFORNIA SAVINGS AND LOAN LEAGUE*

1. In 1962 it was contended that too much savings were being channeled into housing. Congress increased savings and loan taxes to divert some of these savings to fill other credit needs. The flow of savings into savings and loan associations has declined, and there is less mortgage credit available today than in 1962. A further increase in taxes will further decrease the mortgage funds and will tend to raise the cost of such funds.

2. In 1962 Congress created a differential between taxes paid by savings and loan associations and by banks so as to ensure that savings and loans could continue to provide the major supply of mortgage credit. The record is clear that optional lenders leave the mortgage market when alternative investments are available. A continuation of this tax differential is necessary to ensure the continued existence of savings and loan associations as totally committed to the mortgage market. Under both the House Bill and the Treasury proposal, the effective tax rate on savings and loans would be higher than that imposed on banks.

3. Present provisions of the tax law impose restrictions on the lending activities of savings and loan associations. These restrictions should be removed and left to regulatory law.

4. If the alternatives available to the savings and loan business are the House-passed tax reform bill or the Treasury proposal the California Savings and Loan League would support the Treasury proposal with important modifications. We point out that there must be greater incentives and higher ceilings than those suggested by the Treasury.

The California Savings and Loan League has in its membership 250 savings and loan associations whose assets exceed $30 billion. President of the League is Wm. Moseley Jones, President Elect is D. W. Ferguson, and Executive Vice President is Franklin Hardinge, Jr.

* Submitted by Franklin Hardinge, Jr., Executive Vice President

33-758 O-69—No. 4—10

Position of the California Savings and Loan League on H.R. 13270

I appear in opposition to those provisions of the House Bill providing for increased savings and loan association taxation.

The share of national savings going into family shelter has become increasingly inadequate over the past several years. Housing is already at the bottom of the totem pole. The situation is growing more, not less critical. Only last Tuesday, Senator Proxmire told the Banking and Currency Committee that housing starts were down 30% since January, and would continue to decline. Because funds are not available for shelter, many families can neither sell nor buy a house at a time when the total housing inventory is grossly inadequate. We believe the House proposals, if enacted, would accelerate the trend of money out of shelter financing. Further, we believe that the same consinderations that make the House Bill grossly unfair to home-financing specialists will be the cause of this acceleration.

Savings and loan associations are required under federal law to make large appropriations to the federal insurance reserve without regard to true net income or income after taxes. Associations, even under the present tax law, have difficulty meeting these present reserving requirements. The House Bill would tax these inaccessible mandatory reserves as income. These additional taxes will place us in the position where any substantial growth, even if possible, will put us in violation of the insurance reserve regulation. If these additional tax burdens are placed upon us it will be very difficult for us to increase our lendable funds. Most importantly, high interest rates on hom loans will be frozen into the system because we must make the money meet our reserving requirements and higher taxes.

In 1962 Congress determined to increase taxes greatly from savings and loan associations. In part this action of Congress was in response to the contention that prior favorable tax treatment channeled too much public savings into housing rather than permitting funds to be allocated by free market forces to the types of credit demand that would pay the most for those savings.

Nevertheless, Congress intended to preserve the concept that more favorable tax treatment should be accorded savings and loans than to optional lenders in order to assure adequate funds for family shelter.

The House Bill would reverse this treatment. The House proposal would increase the tax on savings and loans, as a percentage of taxable income, from 16.9% to 31%, while increasing the bank rate only from 23% to 27.5%, so that for the first time the rate on savings and loans would exceed that on banks. Exhibit A. But by more objective tests savings and loan associations are already excessively taxed. The 1962 tax increase severely hurt savings and loan associations, and has combined with inflation to produce the present grossly unsatisfactory home-financing situation which the new proposals would exacerbate.

In 1963 California savings and loan associations provided 58% of the total funds loaned on real estate of all types, commercial, industrial and residential, by institutional lenders in California. But substantially the entire savings and loan share of real estate loans was for residential financing. In 1968, the percentage of all such real estate loans in California made by savings and loans was only 39.5%. Exhibit B. The lesser savings and loan share of the mortgage market in recent years shows the diversion of funds from long-term, single family home financing to commercial and industrial loans in which other institutional lenders have placed their money. This in turn has produced the present critical shortage of funds for family shelter. The shift in savings since 1963 has gone to commercial banks. Table C demonstrates how the decline of savings growth has impaired the ability of savings and loans to make real estate loans. The table also reveals that banks have been steadily reducing their total real estate lending nothwithstanding the fact that their savings growth has been at its greatest during this period.

The adoption of the House proposals would accelerate this diversion of money away from family shelter. While the House proposals would transfer to the Treasury, in the form of taxes, an increased percentage of the total gross income of these institutions, the dollar amounts so realized by the Treasury will eventually be less than if these provisions were not enacted, because of the financial harm these proposals would do to savings and loans and to those who use mortgage credit.

Governments have alternatives, sometimes overlapping, for the provision of money for housing. The alternative which in the United States has provided the most funds for this purpose is sponsorship of a type of institution required by law to place the bulk of its money in the financing of homes regardless of whether other investments are more attractive. This is the savings and loan association. While the savings and loan association must compete in the marketplace for available money against all other forms of investment, it must place that money only in long term loans on homes. To succeed, it must be able to compete in the marketplace for savings against lenders who can pick and choose their investments.

But an additional national policy is that shelter financing be made available to families on a basis which spreads the cost over periods as long as 25 or 30 years with no increase in monthly payments over that period.

As a result savings and loan associations' assets are predominantly long-term home loans. By way of example, at the end of 1968 California savings and loan associations held $25.2 billion in mortgage loans of which $24.2 billion were neither insured nor guaranteed. At the same time these associations held $24.3 billion in savings accounts.

If savings and loan associations are taxed without regard to this dominant factor that most of their funds are invested in long-term home loans, they are unfairly taxed and as a consequence become non-competitive. They cannot meet the marketplace price for money. The money that would otherwise go to them to provide shelter for families instead goes to others to finance corporate acquisitions, or other demands of the economy more rate competitive and flexible than is family shelter.

Exhibit D gives selected average ratios for member commercial banks and for insured savings and loan associations in the United States. These tables show that the bank profit ratio before taxes but after losses (expressed as a percentage of average assets) dropped only from 1.36 to 1.06 from the period 1961 to 1967, even though those banks increased the amount that they were paying for their money by 145%. In the same period although insured savings and loans could raise their offering price for public savings by only about 25%, their profit ratio before taxes and after losses dropped from .98 to .52. During this period, 90 days notes of commercial banks have been replaced or renewed at interest rates reflecting the market, and therefore inflation. A 30 year loan held by a savings and loan has the same monthly payments and same interest rates now as when it was made.

It is not proper to argue that a fair system of taxation can ignore the operational restrictions placed on savings and loan associations. The House Bill, if it becomes law, will condemn great numbers of families to continued inadequate shelter, and it will have this effect because it is unfair taxation.

The Treasury proposal for taxation of financial institutions is more realistic. The 5% deduction for both banks and savings and loan associations suggested by the Treasury against interest income from residential mortgage loans recognizes the inherent limitations upon long-term home loans as a form of investment. It is designed to cause lenders to voluntarily invest in home loans through appropriate tax treatment.

But the proposed incentive percentage is insufficient. Under its operation there is but slight tax benefit for the lender who has 75% or more of his portfolio in residential loans as contrasted to the lender whose residential loans are 50% or less of his total portfolio. In a low earnings year the 40% ceiling imposed under the Treasury suggestion would eliminate all or a portion of the deduction provided by the incentive percentage, at a time when the deduction may be of critical importance. We suggest that the appropriate incentive deduction would be 10% of the interest from residential loans and that such deductions should be permitted to total up to 50% of income.

As further evidence that there must be an adjustment in both the percentage of deduction from income as well as the ceilings imposed by the Treasury proposal, we point out the comparative effective tax rates between banks and savings and loan associations. With only a 5% incentive deduction and a limit of 40% of net income for such deduction, the minimum effective tax rate on a savings and loan association would be 30% and for the more profitable and efficient association the effective rate could be as much as 42%. On the other hand the Treasury proposal would increase the effective rate now paid by the banks from 23% to 25.5%. The effective tax rates under the House Bill for banks would be 27%.

The Treasury proposal implicitly assumes that the present tax definition of savings and loan associations will be discarded. This industry is unique in that an elaborate schedule of percentages on investments and operations is written into the tax law to serve as a definition of a savings and loan association, overriding in practical effect basic supervisory statutes and regulations, and essential public need. As an illustration, too much investment in low cost, multi-family housing for the poor under the present tax definition would disqualify a savings and loan association.

This is a matter for supervisory statutes and regulations, not for tax law. We suggest that, in lieu of the present elaborate definition, every savings and loan association insured as such by the Federal Savings and Loan Insurance Corporation be considered, for tax purposes, to be a savings and loan association.

The conversion period under the Treasury plan should be extended to the ten years provided by the House Bill. Further, care should be exerted that the deduction allowable from mortgage interest income is clearly adequate to attract optional lenders into the home-financing field.

Regardless of the adequacy of the 5% suggested by the Treasury to attract funds into choice home loans, the 5% suggestion is clearly inadequate to attract funds where they are most

needed and the problems greater -- low and middle income family shelter. We recommend a higher figure -- at least 12% -- for income from loans to provide middle and low income family shelter as from time to time defined by Executive Order. These families cannot be deprived of shelter financing because of the cost of lending to them. Shelter financing cannot be totally at the mercy of the marketplace. The base should not be a narrow definition of "interest", but should be income from residential real estate financing.

The modifications, discussed above in the Treasury proposals, are essential to the national interest.

Subject to these critical changes, the California Savings and Loan League endorses the Treasury proposal. The House Bill, on the other hand, would atrophy home-financing funds from savings and loan associations without providing an alternative source of funds for family shelter.

The impact of greater tax on savings and loan associations on home financing is beyond measure. There are no other lenders who would replace the void in home financing left by the inability of savings and loan associations to provide for traditional volume of real estate credit.

Certainly the Treasury proposal has as its objective a tax incentive to encourage lenders to make residential real estate loans. However, the tax proposals would not directly stimulate the availability of funds for residential lending. In a period when interest rates have been rising because the demand for capital is outstripping supply, it would seem desirable that tax incentives to the small saver be made a part of proposals under consideration to encourage more savings. This type of approach would also be anti-inflationary. The most logical implementation of the suggestion would be to provide a tax abatement of all or a portion of the interest received by thrifty citizens of this country from their savings in passbook deposits up to the earnings on accounts of $15,000. In effect, this would be making these savings accounts more attractive without raising interest rates and thus not creating a situation where compensating increases would have to be made in interest rates on residential real estate loans. We believe that to the extent savings is stimulated the loss in revenue from the abatement of taxes on interest earned on savings accounts would be more than offset by taxes on the profits from the application of those savings to home construction.

EXHIBIT A

CALIFORNIA SAVINGS & LOAN LEAGUE
Changes in Effective Tax Rates of Banks
and Savings & Loan Associations As Proposed By
Tax Reform Bill HR 13270
(Using 1966 for illustrative purposes)

	Under Present Law		Proposed Law	
	Percentages of Econ. Inc.	Amount (Millions)	Percentage of Econ. Inc.	Amount (Millions)
BANKS				
Total economic income	100.0%	$3643	100.0%	$3643
Tax exempt interest	33.2%	1209	33.2%	1209
Transfer to loan loss reserves and other tax benefits	9.4	342	(1.3)	(48)
	42.6%	$1551	31.9%	$1161
Taxable income	57.4%	$2092	68.1%	$2482
Tax @ 40.4%		$ 845		$1003
Tax as % of economic income		23%		27.5%
SAVINGS & LOANS				
Total economic income	100.0%	$ 579	100.0%	$ 579
Tax exempt income	1.2%	$ 7	1.2%	$ 7
Transfer to loan loss reserves and other tax benefits	56.6	321	23.8	111
	57.8	328	[illegible]	[illegible]
Taxable income	42.2%	$ 251	[illegible]	[illegible]
Tax @ [illegible]		[illegible]		[illegible]
Tax as % of economic income		[illegible]		[illegible]

EXHIBIT B

CALIFORNIA

Estimated Gross Real Estate Lending (in billions of dollars)

	Savings and Loans		Banks		Insurance Companies		Total all major institutional lenders	
	$	%	$	%	$	%	$	%
1963	7.90	58.4	3.23	23.9	2.39	17.7	13.52	100.0
1964	7.43	53.6	3.64	26.3	2.78	20.1	13.85	100.0
1965	6.10	48.4	3.53	28.0	2.97	23.6	12.60	100.0
1966	3.10	36.6	2.86	33.8	2.51	29.6	8.47	100.0
1967	3.99	42.9	3.09	33.3	2.21	23.8	9.29	100.0
1968	4.06	39.5	3.54	34.4	2.68	26.1	10.28	100.0

EXHIBIT B

EXHIBIT C

CALIFORNIA & UNITED STATES NET CHANGE IN RE LOANS VS SAVINGS GAINS

NET INCREASE IN RE LOANS FOR S&Ls & BANKS
(In Billions $)

Year	Savings & Loans		Commercial Banks	
	Insured California	All-Oper. U.S.	California	U.S.
1968	$1.6	$8.9	$ .7	$6.7
1967	1.1	7.8	.2	4.6
1966	.3	3.9	.3	4.7
1965	1.6	8.9	.5	5.7
1964	2.9	10.4	.5	4.6
1963	3.7	12.2	.9	4.8

SAVINGS GAINS FOR S&LS & BANKS
(In Billions $)

Year	Savings Gains Savings & Loans		Gain In Time Deposits Commercial Banks	
	Insured California	All-Oper. U.S.	California	U.S.
1968	$ .8	$ 7.0	$1.9	$20.6
1967	2.3	10.6	1.6	23.7
1966	.2	3.7	1.4	12.1
1965	1.7	8.4	1.7	20.0
1964	2.8	10.6	1.4	15.7
1963	3.2	11.1	1.3	13.4

ASSETS TO RE LOANS--CALIFORNIA & U.S.
(In Billion $)

Year	Savings and Loan Associations						Commercial Banks					
	California			United States			California			United States		
	RE Loans	Assets	% of Assets	RE Loans	Assets	% of Assets	RE Loans	Assets	% of Assets	RE Loans	Assets	% of Assets
1968	$25.2	$29.4	85.6	$130.8	$152.8	85.6	$9.2	$52.1	17.7	$65.3	$500.2	13.1
1967	23.6	27.9	84.4	121.9	143.6	84.9	8.5	46.7	18.2	58.7	450.7	13.0
1966	22.5	26.4	85.1	114.1	134.0	85.1	8.3	42.6	19.4	54.1	402.9	13.4
1965	22.2	25.8	85.8	110.2	129.4	85.1	8.0	39.8	20.0	49.4	375.4	13.2
1964	20.5	23.9	86.1	101.3	119.4	84.9	7.5	30.7	24.5	43.7	276.1	15.8
1963	17.7	20.7	85.5	90.9	107.6	84.6	7.0	28.4	24.7	39.1	253.4	15.4

Source: Federal Deposit Insurance Corporation, Reports of Call; FHLBB, Selected Balance Sheet Data; FHLBB, Combined Financial Statements

EXHIBIT D

PROFIT SQUEEZE
United States
Banks vs S&Ls

	Member Commercial Banks					Member S&Ls				
	Ratio to Average Assets			Change in Basis Points		Ratio to Average Assets			Change in Basis Points	
Items In Numerator	1961 %	1967 %	1968 %	1961-67 %	1961-68 %	1961 %	1967 %	1968 %	61-67 %	61-68 %
Gross Income	4.42	5.39	5.63	+97	+121	5.60	5.83	6.02	+23	+42
Loan Income	2.75	3.55	3.73	+80	+98	4.70	5.02	5.13	+32	+43
Total Money Cost*	.86	1.88	2.06	+102	+120	3.43	4.23	4.24	+80	+81
Spread between Gross Income & Money Cost	3.56	3.51	3.57	-5	+1	2.17	1.60	1.78	-57	-39
Operating Cost**	2.11	2.20	2.20	+9	+9	1.20	1.06	1.08	-14	-12
Profit before taxes but After nonoperating Gains & Losses	1.36	1.06	1.04	-30	-32	.98	.52	.72	-46	-26

* Includes interest paid on time deposits in commercial banks plus interest paid on borrowed funds. Includes dividends paid on withdrawable shares for S&Ls plus interest paid on borrowed funds, plus stock dividends paid by state-chartered S&Ls.

** Excludes interest paid for borrowed funds for both banks & S&Ls and interest paid on time deposits at banks.

Source: Federal Home Loan Bank Board: Combined Financial Statements.
Board of Governors, Federal Reserve System.
Federal Reserve Bulletin.

PART B—ADDITIONAL STATEMENTS

September 10, 1969

The Honorable Members of the Senate Finance Committee
The United States Senate
Washington, D. C.

Gentlemen:

As suggested by your Chief Counsel, Mr. Tom Vail, I would like to direct your Committee's attention to a serious problem that exists in the interpretation of sections 541 through 565 of the Internal Revenue Code (personal holding companies) and its application to banks of limited powers and the inability of many lending or finance companies to meet the exemptions afforded in section 542 (c) (6).

First of all, permit me to thank you for the opportunity of having this testimony included in the printed record of the hearings on tax reform legislation.

The problem that has arisen in this matter has to do primarily with the interpretation and application of section 542 (c) which section defines exceptions from the personal holding company designation as defined in section 542 (a).

Section 542 (c) (2) states that a bank as defined in section 581 of IRC is to be afforded an exemption from personal holding company taxes. At the present time, it appears that IRS is not willing to interpret section 581 so as to include industrial loan associations, Morris plan type banks, etc., regardless of the fact that these type of institutions have already been determined to be banks within the meaning of section 581 in four previous cases decided in the Federal Courts. The cases referred to are as follows: (1) Valley Morris Plan vs. Commissioner, 305 Fed. 2nd 610; (2) Morris Plan Bank of New Haven vs. Smith, Collector 125 Fed. 2nd 440; (3) Staunton Industrial Loan Corporation vs. Commissioner, 120 Fed. 2nd 930; and (4) Mutual Savings and Loan, Inc. vs. C.I.R., 1941 B.T.A. 1204.

Section 581 states that "bank means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U. S. C. 248(k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision

over banking institutions." I will attempt herein to bring to light some of the injustice built into the personal holding company portion of the tax code, and to offer some suggestions with regard to affording the relief required to permit legitimate companies to remain in business.

At this writing, Norfolk Industrial Loan Association (NILA), of which I am President, is embroiled with IRS over the question of whether NILA is afforded an exemption from personal holding company taxes by the exceptions afforded in section 542 (c) (2) and/or 542 (c) (6). The tax years involved are 1964, 1965 and 1966.

To give you some background on this case, I would like to state that NILA was licensed in 1959 as "a bank of limited powers" under Chapter 5, sections 6.1-227 through 6.1-242 inclusive of the Code of Virginia. NILA is subject to supervision and examination by State Bank Examiners of the Bureau of Banking, State Corporation Commission of the State of Virginia. As of December 31, 1964, NILA had loans and discounts in the aggregate sum of $1,604,415.06 and more on December 31, 1965.

With regard to a substantial part of the business being that of receiving deposits, NILA had outstanding as of December 31, 1964, certificates of debenture in the amount of $770,500, part of which represented funds placed with the Association through fiduciary relationship. In 1964 NILA had a total of $357,157 in funds which it had received from guardians of estates, infants, incompetents, etc. In many instances these funds were placed with the Association by order of Courts of Record of the State of Virginia. As you gentlemen can readily see there is no reason why this Association should not meet the definition of a bank as defined in section 581. Yet the facts of the matter are that NILA has been declared by IRS as not meeting the definition of a bank as defined by section 581 and has been assessed $95,246 in additional taxes and interest (no penalties) for the years 1964 and 1965. A claim has been filed in the United States District Court in Norfolk, Virginia, for the return of these taxes which NILA feels were improperly and excessively assessed.

Section 542 (c) (6) outlines exemptions afforded lending or finance companies if they meet certain tests as defined in subsections (A) through (D) inclusive. There is no way that a great many lending and/or finance companies can meet the requirements of these tests unless they are willing to greatly change the type of business they are handling, plus dismiss key executives, managers and employees who are also shareholders so as to be in a position to meet the test outlined in subsection (C) which subsection refers to expenses directly allocable to the active and regular conduct of

lending and finance business. To qualify expenses must equal or exceed 15% of the ordinary gross income from active and regular conduct of lending and finance business. This section states in effect, and has been interpreted to mean, that when attempting to meet its requirements you cannot consider salaries paid to officers, managers and employees who are shareholders, or members of their families, even if they are not stockholders, nor can you consider interest paid on funds borrowed for relending when attempting to meet the 15% test. As you gentlemen can readily see, the largest expense a lending or finance company generally has is the salaries of its principal officers, managers, employees, and the interest it pays on funds borrowed. When you eliminate these two items, you eliminate the larger portion of expenses that a lending or finance company has and thereby create a situation whereby many lending and finance companies fail to meet the tests outlined for the exemption afforded by section 542 (c) (6).

Our research into the legislative history of the personal holding company tax section indicates that it was never the intent of Congress to subject legitimate industrial loan associations, Morris Plan banks, and lending or finance companies to the unreasonable taxes (70% of undistributed personal holding company income) called for in the personal holding company tax section.

In fact, Mr. Sidney L. Cohen, CPA, Boston, Massachusetts, in an article written for Prentice-Hall, Inc. in their 1966 edition states, "Section 542 (c) (6) is a revelation in tax legislation, since it simplified its prior counterpart by streamlining the PHC exemptions for finance companies. Thus, the lending and finance company exception provides a more comprehensive and livable escape hatch for the PHC classification." He further states, "The House report on the Revenue Act of 1964 concluded that it would be desirable to have one exclusion available for all four of the above categories of lending or finance companies. At the same time it saw no need for purposes of the personal holding company provision to restrict the type of loans which these companies could make since this is properly a matter of regulation of State law governing these lending or finance businesses."

Mr. Cohen further stated, "Because of the harshness of the penalty of the surtax, the Courts have commented that if Congress had intended otherwise it would have provided for relief. They have gone along with the letter of the law and applied the technical rules as the law provides. However, a study of the legislative history shows that with the lapse of time, Congress has provided more and more relief to deserving legitimate cases. Insofar as certain types of finance companies are concerned this relief has taken the form of a percentage expense test, favorable treatment given to rentals,

group affiliates, bank affiliates, a redefinition of the gross income percentage test and other technical changes."

Therefore, as you gentlemen can see, the intent of Congress is one thing while the interpretation and application of the exceptions from the personal holding company taxes are in reality another.

It is the opinion of this Association, its CPA's and attorneys that section 542 (c) (6) is in fact a trap that many legitimate licensed institutions are subject to being caught in. If relief is not forthcoming, or if IRS does not take a more reasonable attitude towards it, you are going to see a situation develop where many companies including this Association are going to be forced to liquidate or merge with large publicly held companies because of their inability to meet the exceptions afforded in the sections referred to herein.

Now I'm sure, some of you gentlemen will suggest that escape from PHC classification can be obtained by meeting the stock ownership test outlined in section 542 (2) by selling its stock to a larger number of shareholders and thereby avoiding the five individuals owning 50% or more in value stock ownership test. This again does not necessarily work on the main streets of America. In fact, in the case of this Association, NILA has been attempting since 1959 to go public with no less than six stock brokerage firms including some of the largest on the East coast. In addition, NILA has mailed more than 60,000 pieces of mail in an attempt to interest residents of the State of Virginia in purchasing its securities which include common and preferred stock. At this writing, NILA has 132 common and preferred stockholders, and still has a situation whereby five stockholders own more than 50% in value of its stock. The reason being that from time to time NILA is forced to sell stock to its existing principal stockholders in order to avoid being subject to the thin corporation doctrine.

The problem with the present tax code as I view it from Granby Street here in Norfolk, Va., is that it is no longer workable. It is far too complicated. As a corporate executive I can truthfully say that I have never personally met a CPA or an attorney who has sufficient knowledge of the present tax code to satisfy the requirements of corporate executives. What is happening in this Country is that the Federal bureaucracy has been tremendously successful in alienating the younger generation and the system is now being extended to promote a tax revolt the likes of which this Country has never witnessed before. In my opinion, approximately 70% if not all of the present tax code should

be completely scrapped and a greatly simplified code should be adopted in its place. The present code is filled with traps and pitfalls that defy the abilities of tax experts to understand. There is very little solid ground left that CPA's and tax attorneys can use to state without question that their judgment in a particular matter is sound and unassailable. There is no reason that the code cannot be simplified so that the average CPA can understand it. As I see it, most corporate taxpayers do not object to paying reasonable taxes; but they want the traps removed so that they know where they stand and what they owe and that the advice they are forced to rely on can be trusted. I personally have reached the point where I have lost complete confidence in CPA's and tax lawyers because of events that have transpired in our dealings with IRS in the last several years.

I would like at this point to go into some detail in an effort to point out the unreasonableness and the injustice which is the end result of a corporation caught in the personal holding company trap.

In the case of NILA it should be noted that IRS arrived at a determination of its assessment for additional corporate income taxes by substantially reducing the addition to reserve for losses set up by the taxpayer from $42,000 to $2,019; however, this is another matter which will soon be litigated in court. If we accept the Internal Revenue Service's adjustment in the reserve for losses account of the taxpayer, we arrive at a 1964 corporate income of $30,786.77 for the calendar year ended December 31, 1964. On this regular corporate income, NILA has paid an assessed tax of $50,576.22, which represents 164% of its normal corporate income, assuming that it was not a personal holding company.

The situation for the year 1965 is that NILA has been assessed and has paid a tax equal to 120% of its regular corporate income, again assuming that it is not a personal holding company.

The effect of the payment of these taxes and interest (not including any penalties whatsoever) on the Association's financial position is that they wipe out all but $2,019 of NILA's reserve for losses account, completely eliminates its retained earnings account, plus eliminates all of its paid in surplus and impairs the capital structure of the Association. By their action, IRS has endangered and impaired the safety of hundreds of thousands of dollars in funds deposited with NILA by guardians of estates, infants, incompetents, and the savings of numerous elderly people and small hard working day to day workers whose investment in NILA's certificates of debenture in many cases represents most of their cash savings.

If any of you gentlemen can offer a defense for this type of injustice, I would like to hear it.

In the event this Committee is desirous of affording some measure of relief for small closely held industrial loan association, Morris Plan type banks, and lending or finance companies, it would be my suggestion that section 581 of the code be amended so as to eliminate the following portion, "a substantial part of the business of which consists of receiving deposits." This would have the effect of recognizing industrial loan associations and Morris Plan type banks for what they are and that is, banks of limited powers, legitimately licensed and supervised by the various states.

In addition, it would be my recommendation that subparagraph (i) of section 542 (c) (6) subparagraph (B) Exceptions, be eliminated entirely or amended to read 120 months, in place of 60 months.

I furthermore recommend that section 542 (c) (6) subparagraph (C) be amended to permit as a deduction of expense in arriving at the 15% expense test of ordinary gross income so as to include compensation of employees of lending or finance companies regardless of whether or not they are shareholders and interest expense paid for the borrowing of funds for the conduct of its lending or finance business. I see no reason why small lending or finance companies should be forced into a position of dismissing or requiring its officers, managers and/or employees to sell shares of stock that they might own in the company which they are employed by in order to meet the 15% deductions test outlined in this section. To me this is gross discrimination against small lending and finance companies.

Unless some relief is forthcoming promptly you will see a situation in which hundreds of small companies will be forced to merge or liquidate in order to escape the injustice of the personal holding company tax.

I sincerely hope that this Committee will see fit to amend the Internal Revenue Code so as to permit small closely held legitimate licensed industrial loan associations, Morris Plan type banks and lending or finance companies to survive. Thank you.

Respectfully submitted,

NORFOLK INDUSTRIAL LOAN ASSOCIATION

D. H. Burlage
President

ELIZABETH H. KURY, Esq.*
KURY and KURY
216 Market Street
Sunbury, Pa. 17801

Statement Before Senate Finance
Committee on H.B. 13270.

PROFITABLE CONTRIBUTIONS BY A CHURCH, HOSPITAL, SCHOOL OR OTHER TAX EXEMPT ORGANIZATION TO A NON-EXEMPT TRUST SHOULD BE EXCLUDED FROM PROPOSED SECTION 321(b).

If H.B. 13270 is enacted without the amendment herein submitted it will have a serious adverse affect on the churches, hospitals, schools and other charitable organizations which must compete with private industry to attract highly qualified personnel. The amendment proposed herein consists of the underlined portion of proposed new Section 321(b):

"(b) NON-EXEMPT TRUSTS AND NONQUALIFIED ANNUITIES.-

"(1) BENEFICIARY OF NON-EXEMPT TRUST. - Section 402(b) (relating to taxability of beneficiary of non-exempt trust) is amended to read as follows:

"'(b) TAXABILITY OF BENEFICIARY OF NON-EXEMPT TRUST. - Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of the employee in accordance with section 85 (relating to restricted property). If the employer is described in Section 501(c) and exempt from tax under Section 501(a) and the beneficial interest of the employee in such contributions is forfeitable at the time the contributions are made, the preceding sentence shall not apply. The amount actually distributed or made available to any distributee by any such trust shall be

*LL.B. University of Pittsburgh, 1963; LL.M. in Law of Taxation, N.Y.U., 1966; admitted to practice before all courts of Pa.

taxable to him in the year in which so distributed or made available, under section 72 (relating to annuities), except that distributions of income of such trust before the annuity starting date (as defined in section 72(c)(4)) shall be included in the gross income of the employee without regard to section 72(e)(1) (relating to amount not received as annuities). A beneficiary of any such trust shall not be considered the owner of any portion of such trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners).'

"(2) BENEFICIARY UNDER NON-QUALIFIED ANNUITY. - Section 403 (relating to taxation of employee annuities) is amended by striking out subsections (c) and (d) and inserting in lieu thereof the following new subsection:

"'(c) TAXABILITY OF BENEFICIARY UNDER NON-QUALIFIED ANNUITIES OR UNDER ANNUITIES PURCHASED BY EXEMPT ORGANIZATIONS. - Premiums paid by an employer for an annuity contract which is not subject to subsection (a) shall be included in the gross income of the employee in accordance with section 85 (relating to restricted property). If the employer is exempt from tax under section 501(a) or 521(a), the preceding sentence shall apply only to that portion of the premiums paid which is not excluded from gross income under subsection (b). The amount actually paid or made available to any beneficiary under such contract shall be taxable to him in the year in which so paid or made available under section 72 (relating to annuities).'

"(c) CLERICAL AMENDMENT. - The table of sections for part II of subchapter B of chapter 1 is amended by adding at the end thereof the following new item:

"'Sec. 85. Restricted property.'

"(d) EFFECTIVE DATES. - The amendments made by subsections (a) and (c) shall take effect upon the date of enactment of this Act. The amendments made by subsection (b) shall apply to transfers made and to premiums paid after August 4, 1969."

Present Law

Under Section 402(b) of the present law the employee-beneficiary of a non-exempt trust does not include in his gross income contributions made by a tax exempt charitable employer (or any other employer) if the employee's beneficial interest in the contribution is forfeitable when made. Only the amounts distributed to him are taxed, and such distributions are taxed in the year of distribution under Section 72 (relating to annuities).

Many churches, hospitals and universities which cannot compete with profit-corporations for highly qualified personnel by offering the pensions and other fringe benefits that the large corporations offer have used Section 402(b) to provide retirement benefits that they could not otherwise provide. Charitable institutions for which it is impracticable or undesirable to set up a tax exempt trust in conjunction with a qualified pension plan under Section 401 can easily set up a non-exempt trust under Section 402(b) by a simple employment contract with the employee and trust agreement with a bank. The charitable employer then simply mails periodic contributions as contracted for to the trustee and has no further responsibilities with respect to investments and distributions. Contributions are conditioned on the employee's future performance of substantial services and/or such other conditions as are advantageous to the employer, and do not vest or become non-forfeitable for a period of usually two to five years.

A similar provision of present law, Section 403(b), provides that premiums paid by a tax exempt charity for a non-forfeitable annuity are not includable in the employee's gross income except to the extent that they exceed twenty percent of his includable compensation. New Section 321(b)(2) specifically retains this exclusion which in present law applies only to tax exempt organizations.

The employee usually pays for at least part of retirement benefit provided by either the annuity or the tax-exempt trust by contracting for a lesser salary than he would otherwise be entitled if he did not elect to have his employer contribute to the trust or purchase retirement annuities. The trust or annuities are attractive, however, because of the tax deferment until payments are received. The provisions of Sections 402(b) and 403(b) have not been abused by charitable employers and have not opened the door to any treasury raid. It is a very,

very rare contribution or premium by a tax exempt institution or distribution or payment to a beneficiary which equals or exceeds $10,000 - the amount which new proposed Section 1354 permits any individual to receive from any employer as deferred compensation payment without tax penalty.

The non-exempt trust is a more attractive device than an annuity for funding a retirement program, however, because with competent management the trust fund will grow to provide a much more adequate retirement benefit than an annuity program. The institution generally prefers it to a straight deferred compensation payment because it does not wish to fund payments out of current income in the year of payment and does not wish to become involved in the investment management and bookkeeping incident to the funding of deferred compensation payments.

Proposed Changes by H.B. 13270

Under proposed new Section 321(b)(1) all contributions by a charitable employer to a non-exempt trust would be taxable to the employee in the year they became non-forfeitable, by reference to proposed new Section 85. Where forfeitability is conditioned on performance of future services this would have disastrous consequences in the year of retirement or lawful termination of employment, for it would require the inclusion of the entire trust fund in the employee's gross income for that year. It is difficult to imagine forefeiture conditions which would remain in effect after retirement, and, therefore, proposed Section 321(b)(1) effectively kills future use of forfeitable non-exempt trusts by tax exempt organizations.

Reasons Why H.B. 13270 Should Be Amended To Exclude Forfeitable Contributions By Tax Exempt Organizations From Provisions of Section 321(b)(1):

1. It is socially desirable to permit these institutions to provide employees with retirement benefits which could not otherwise be financed in competition with industry, through the device of a forfeitable non-exempt trust.

2. This amendment merely corrects an illogical inconsistency in H.B. 13270. It is illogical and inconsistent to defer until payment the tax on premiums paid for non-forfeitable annuities and to tax the accumulated forfeitable trust contributions of a charitable employer in the year they become

non-forfeitable. Surely this result was not contemplated in the drafting of H.B. 13270.

3. Employee trust beneficiaries should enjoy at least as much tax deferment as is made available through straight deferred compensation payments. It is inconsistent to penalize the employee-beneficiary of a non-exempt trust by taxing him on any contributions in the year made or the year they become non-forfeitable when proposed Section 331 provides total and complete tax deferment without tax penalty from the year contracted until the year of payment on any straight deferred compensation payment of less than $10,000.

The general reasons for changing tax treatment of deferred compensation stated on page [illegible] of the Committee Report argue even more strongly for the amendment sought herein deferring tax on forfeitable contributions by charitable institutions to non-exempt trusts:

> "It is anomalous that the tax treatment of deferred compensation should depend on whether the amount to be deferred is placed in a trust or whether it is merely accumulated as a reserve on the books of the employer corporation. An employee who receives additional compensation in the form of a promise to pay him that compensation in the future made by a large, financially sound corporation, is probably as likely to receive the compensation as an employee whose deferred compensation is placed in trust."

If changes in the treatment of deferred compensation are justified on the very sound theory that a deferred compensation payment is as certain to be received as a trust distribution, surely tax should be deferred on a trust contribution to a like extent without penalty, especially if the trust contribution is forfeitable in the year of contribution. The beneficiary of a forfeitable contribution to a non-exempt trust should be in no worse position than if the charitable employer promised to make a deferred compensation payment.

To provide the same benefit through a straight deferred compensation payment as can be provided through the trust the charitable employer must either (1) pay out more dollars in the year of payment than under the trust arrangement yearly or (2) manage its own investment program to fund the benefit.

Most institutions which use the trust device cannot commit themselves to an unfunded deferred compensation program and are not equipped to manage investment programs to fund either single-employee trusts or trusts which pool the funds of several or many employees. A trust arrangement involving periodic payments to a bank, on the other hand, is economical and convenient.

4. The failure to exclude forfeitable contributions to non-exempt trusts by charitable organizations was probably an oversight due to the fact that Section 402(b) is general with terms and not specifically applicable to charitable organizations. See the Committee Report at page 89, which indicates an intention to preserve the provisions of the present law which provide tax deferment on retirement benefits to employees of tax exempt institutions.

5. The attractiveness of forfeiture provisions to the charitable institution as a means of insuring the loyalty of employees and the non-violation of employment contracts should not be overlooked. Such protection is not as readily afforded by either the Section 403(b) annuity or straight deferred compensation arrangement.

# # # # # #

Statement of J. Austin White, J. A. White & Company, Central Trust Tower, Cincinnati, Ohio, to the Committee on Finance, U. S. Senate, relative to Sec. 443 "Treatment of Bonds, etc. Held By Financial Institutions," of H.R. 13270, a bill to reform the income tax laws.

- - - - - - - - - - - - - - - - - -

Probably the most widespread and vocal opposition to the tax reform bill, as passed by the House, is against two sections: (1) the proposal to include interest from state and municipal bonds in the "limit on tax preferences" (Sec. 301 of the bill); and (2) the proposal to include such interest in the "allocation of deductions" (Sec. 302 of the bill)—and I'm opposed to both of these proposals.

But in this statement I should like to concentrate on one provision of the bill (Sec. 443) about which there is not heard so much hubbub of opposition, but which, if allowed to stand as is, will cause undue and unjust hardship to thousands of banks throughout the nation. In the words of the House Ways and Means Committee (on page 130 of its "House Report No. 91-413, Part 1"), this Sec. 443 "eliminates the present preferential treatment accorded to financial institutions' transactions in corporate and Government bonds and other evidences of indebtedness by providing parallel treatment of gains and losses on these transactions. Under the bill, financial institutions are to treat net gains from these transactions as ordinary income instead of as capital gains; they will continue to treat net losses from such transactions as ordinary losses as under present law."

Now this sounds fairly innocuous. But I beg your indulgence while I try to point out an amendment that should be added to prevent both undue and unjustly harsh treatment that will result to the thousands of mostly smaller banks across the nation, from the broad application of this Sec. 443 if it is not amended.

By way of introduction, let me say that I am the proprietor of a relatively small municipal bond house, J. A. White & Company, established in Cincinnati in 1937. I own no stock in any bank, and I presently have practically no bonds to sell to banks. But for thirty-five years, since 1934, I have specialized in selling bonds to commercial banks. This, and much "extra-curricular" work done chiefly for my bank clients over these 35 years, give me, I think, a sound basis to speak authoritatively and intimately of the investment policies and problems of commercial banks.

First, let me quote again from "House Report No. 91-413, Part 1" wherein on page 129 under "Reasons for change" the House Ways and Means Committee states (underscoring is mine) "<u>Transactions</u> of financial institutions in corporate and government bonds and other evidences of indebtedness do not appear to be true capital <u>transactions</u>; they are more akin to <u>transactions</u> in inventory or stock in view of the size of the bank holdings of these items and <u>the extent of their transactions</u> in them. Moreover, financial institutions now maximize their tax advantages by arranging their <u>transactions</u> in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years."

Right here, let me state unequivocally that of the 14,000 or so banks in the nation, probably 85% to 90% of them do <u>not</u> follow such a practice of "arranging their transactions in bonds." Those that do follow such a practice are the larger banks. If this Sec. 443 is allowed to become law without an amendment such as I suggest later, the Committee's effort to get at a practice followed by only a relatively few large banks will penalize unduly and, I repeat, unjustly, the many thousands of smaller banks who do not even follow that practice.

Second, please note from the above quotation that the Ways and Means Committee refers five times to "transactions" in bonds. This constant use of the

word transactions, would infer that the Committee's attention was concentrating on at least fairly frequent buying and selling of bonds, as contrasted to the far more common practice amongst the thousands of banks of simply buying bonds once as an investment and holding them to collect at maturity.

My point is that a distinction should be made between "transactions" of buying and selling bonds, and the one-time purchase of bonds for investment that are held constantly to maturity and simply collected when due. When a bank buys a bond and holds it for a year, or three years, or five, ten or twenty years, and then sends it in for collection at maturity, that could hardly be considered "transactions" in bonds, especially in the light of the Committee's further reference as a "reason for change" that "financial institutions now maximize their tax advantages by arranging their transactions in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years."

Quite possibly the Committee did not intend to penalize the legitimate one-time purchase of bonds held to maturity as an investment. Indeed, the actual wording of the bill itself (H.R. 13270, page 264) reads as follows (underscoring mine): "(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL INSTITUTIONS.—For purposes of this subtitle, in the case of a financial institution to which section 585 or 593 applies, the sale or exchange of a bond, debenture, note, or certificate, or other evidence of indebtedness, shall not be considered a sale or exchange of a capital asset." Now certainly sending a bond in for collection when it matures (or is called for payment), could hardly be properly called a sale of the bond. But I cannot be so sure that some Internal Revenue Agent might not call the collection of a bond at maturity an "exchange," for cash, though certainly that would seem to be a strained interpretation of the meaning of the word "exchange."

Our problem here is that many thousands of banks, if indeed not all of them, have purchased bonds at prices below par, for investment, and they fully expect to hold such bonds to maturity. When such bonds are collected at maturity at par (their face value), the bank technically has a gain, which is the difference between the purchase price below par, and the par value collected at maturity. Under a broad interpretation of Sec. 443, without some amendment, this "gain" will far too likely be taxed in full as ordinary income, particularly in view of the broad comment of the Ways and Means Committee quoted at the outset of this statement (from page 130 of "House Report No. 91-413, Part 1"): "Under the bill, financial institutions are to treat net gains from these transactions as ordinary income instead of as capital gains."

But, as I have indicated above, the "net gains from these transactions" should be considered quite differently from the technical "gain" which a bank earns when investing in a bond at a discount below par and holding it to maturity and then sending it in for collection at par. This latter type of gain is not the type of gain which I feel the Committee wanted to tax as ordinary income, since it is really a delayed collection by the bank of part of the investment return at which it agreed to invest in the bond when the bank originally purchased the bond for investment.

At the risk of being too technical, allow me to go into this point a bit further as it forms the basis of my argument for a protecting amendment to Sec. 443. Due to the high interest rates prevailing generally over the past four years (not just in 1969), probably 75% to 85% of the bonds that have been available in the market have had to be sold at discount prices below par, because they were issued in prior years when interest rates were lower. For example, a bond issued say in 1962 with an interest rate of 3 1/4% has not been worth its face value, or par, for the

past several years, because of rising interest rates in general. No one would buy such a bond today, nor last year, nor the year before at its face value. But, a bank might have been willing to invest in such a 3 1/4% bond in 1967 at a yield of 5%. This means of course that the bond would have to be purchased at a discount price, below its par or face value, let us say at 90 cents on the dollar, or 90% of its par or face value. Now, the bank which buys that bond at 90, and holds it to maturity is not reaping a gain of 10% of its face value in the normal connotation of gain, nor, I think, in the sense that the Ways and Means Committee considered "gains from transactions." Rather, this 10% of face value which the bank collects after holding the bond to maturity is just as much a part of the investment return, or yield, as the interest coupons collected semi-annually while the bank owned the bond. The only difference between this "gain" and the interest coupons is that the bank had to wait two years, or five, ten or twenty years to collect this part of its interest, whereas the bank collected the 3 1/4% coupons each year.

So, for all of the above reasons, and, I repeat, to protect many thousands of banks across the country from undue hardship from too broad an interpretation of Sec. 443, I earnestly urge the Committee on Finance to add an amendment to this Sec. 443 to make certain that it does not apply to bonds purchased for investment and held to maturity (or call payment date). This could be accomplished, I believe, by adding the following underscored words to the paragraph quoted above from page 264 of H.R. 13270: "(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL INSTITUTIONS.—For purposes of this subtitle, in the case of a financial institution to which section 585 or 593 applies, the sale or exchange of a bond, debenture, note, or certificate, or other evidence of indebtedness, shall not be considered a sale or exchange of a capital asset," but a bond, debenture, note, or certificate, or other evidence of indebtedness purchased for investment and held to maturity, or to the call payment date if called prior to maturity, shall be considered a capital asset.

Now if, after considering all of the above points, you should perchance still refuse to amend this Sec. 443 to differentiate between "gains from transactions" and the one-time purchase of bonds for investment that are held constantly to maturity, then let me point out the injustice that will be done to many thousands of banks across the nation by the retroactive feature of this Sec. 443 as it stands now. There is no "grandfather clause" in the section as now drawn. There is no consideration given to the effect of this Sec. 443 on prior commitments by a bank, which would be represented by bonds still owned and not yet matured but purchased a year, or three, five, ten or even twenty years ago. The effective date of this Sec. 443 reads simply as follows (from page 265 of H.R. 13270)—"The amendments made by this section shall apply with respect to taxable years beginning after July 11, 1969."

In other words, this Sec. 443 as now drawn will require bluntly that starting next year all bonds owned by a bank will no longer be considered capital assets, regardless of whether the bonds represent new purchases or purchases made five, ten or twenty years ago! I sincerely hope you will agree that it is eminently unfair thus to make this change retroactive.

As stated above, over the past four years or so because of high interest rates, probably 75% to 85% of the bonds available in the market have had to be priced at discounts below their face value, because the bonds had been issued in previous years of lower interest rates—and for the five or six years before that perhaps half or more of the bonds available in the market had to sell at discount prices for the same reason.

This situation has been true of all bonds, Government, municipal and corporate, and as a result, over the past decade practically all of the 14,000 banks throughout the nation have purchased, in the aggregate, hundreds of millions of dollars worth of bonds that had to be purchased at discount prices below face value in order to compete with the declining market, and, most important, many millions of dollars worth of such discount bonds are still owned by many thousands of banks.

Now, here is the important point that deserves your careful and honest consideration. In all of those purchase commitments involving these millions of dollars of bonds, a very important consideration in the making of these commitments was the realization that such bonds would be considered capital assets, and the "gain" represented by the appreciation to par at maturity would be taxed as a long term capital gain. As of course you know the maximum tax rate on such long term capital gains has been 25%, and it was on the basis of such a tax rate that these commitments were made. And now, if you do not amend this Sec. 443 to keep it from being retroactive, you are about to double that tax rate, on commitments made previously, even as long as years ago. I earnestly hope you will agree this would be unjust.

Sec. 443, as now worded, will result in banks having to put into ordinary income taxed at regular rates the full amount of the "gain" represented by the appreciation to par at maturity of the discount on bonds purchased below par. Of the 14,000 banks in the nation, relatively few now earn net taxable income of less than $25,000; so that the vast majority of them pay the regular corporate tax rate now at about 50% (48% plus the surtax). Hence, I repeat, if you do not amend Sec. 443 to keep it from being retroactive, you will in effect be doubling the tax rate retroactively on commitments made even years ago. In the example mentioned previously, of a bank that purchased a few years ago a 3 1/4% bond at 90, the bank in making the commitment understood that the 10% appreciation to par at maturity would be subject to a maximum tax rate of 25%. It would be unfair, and an injustice, to make that bank pay twice as high a tax rate on that appreciation just because the bond matures in 1970 or beyond. The injustice that would be thus done is magnified to great proportions if you realize, as you should, that this simple example would be repeated in hundreds of thousands of commitments <u>previously</u> made by thousands of banks across the nation.

I most strongly urge you to eliminate at least these injustices by amending Sec. 443 with some such wording as the following underscored words added to Sec. 443 as quoted from page 264 of H.R. 13270: "(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL INSTITUTIONS.—"For purposes of this subtitle, in the case of a financial institution to which section 585 or 593 applies, the sale or exchange of a bond, debenture, note, or certificate, or other evidence of indebtedness," <u>purchased after July 11, 1969</u> "shall not be considered a sale or exchange of a capital asset."

Thank you for your consideration.