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TAX REFORM ACT OF 1969

H.R. 13270

PART A—TESTIMONY TO BE RECEIVED THURSDAY, OCTOBER 2, 1969

PART B—ADDITIONAL STATEMENTS

(Topics: General; Standard Deductions; Tax Treatment of Retired Persons; Single Persons)

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

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TAX
TESTIMONY
Henry Bellmon
Thursday
October 2, 1969

Mr. Chairman, Members of the Finance Committee, I appreciate the opportunity to appear to testify regarding HR 13270 and wish to thank you for the courtesy which you have extended to me.

In the short time available, I have attempted to review HR 13270, particularly as to four aspects of the legislation. These are the provisions of the bill that affect the agricultural and petroleum industries, those provisions that relate to municipal bonds, the personal exemption allowed individual taxpayers, and certain administrative procedures of the Internal Revenue Service. I have prepared a statement which I will not read. I ask unanimous consent that it be included in the Record, and I will limit my oral testimony to a brief summary of this statement.

I believe that the main purpose of our tax system should be to raise revenue. During the period since the 1930's, the idea of using our revenue-raising laws to accomplish certain social aims has complicated and caused great confusion in the administration of these laws.

With the passage of a vast quantity of social legislation in other fields, with the increased socially oriented activities of the United States Supreme Court, and with the creation of many additional federal programs to deal with social problems, it occurs to me that any tax reform legislation passed by the present Congress might well take note of the fact that the need for using our tax system for social purposes may no longer require the same high priority.

If this concept can be adopted, the law can be vastly simplified. It can be much more easily understood and followed by individual taxpayers, and it can be much more effectively enforced by those who are charged with its administration.

In a recent conversation with an official at the Internal Revenue Service, I was amazed when he told me that, "if the taxpayers of this country ever discover that the Internal Revenue Service operates on 90% bluff, the entire system will collapse." He further went on to tell me that when he first joined the Service in the 1940's, his reference manuals occupied thirteen inches of shelf space. At the present time, he must rely upon books of instructions and interpretations that make up a total of thirty-three feet of shelf space in his office. Plainly, simplifying of our tax laws should have a high priority. Much of the statement I have prepared for the Record is aimed in this direction.

There seems to be danger, that in its efforts to administer the present complex and confusing law, the Internal Revenue Service is resorting

to tactics which frequently seem to border on coercion. Many innocent taxpayers, who are accused by the Internal Revenue Service of irregularities, find it less costly to pay the additional taxes and penalty than to go to court and prove their innocence. Therefore, I would recommend that a tax reform law include a provision which would allow a taxpayer who goes to court and successfully proves his innocence to recover the costs of such litigation from the Federal Government.

When the present Internal Revenue Code was first put into effect and the $600 personal exemption was established, the purchasing power of our currency was far in excess of what it is today. The present $600 exemption is totally inadequate to meet the living costs of even the most modest American citizen. It is well below the "poverty level" set forth in many federal programs.

Therefore, out of a sense of equity, I believe Congress should immediately adjust the personal income tax exemption upward. If the total adjustment cannot be made in one year, it should be made in stages that will not unduly upset the Nation's economy, but that will assure the American taxpayer that the equity will be established within a reasonable time.

H.R. 13270 contains provisions which strike heavily at the two industries which have done far more than their share in keeping this Nation strong, in holding the line against inflation, and in making us the best-fed people on the face of the earth. I refer to the agricultural, mineral and energy industries which are of such vital importance to the strength, security, and prosperity of this Nation and which are of particular importance to my own State of Oklahoma.

The fact is that agriculture, since World War II and even before, has been in serious financial trouble. As one who has spent most of his adult life in agriculture, I can assure you that except in unusual circumstances, most food and fiber producers have been selling their products at or near the costs of production.

As a result, agricultural operations have not produced the financial resources farmers and ranchers need to improve and conserve our soil, drain or clear new land for production, or develop improved livestock, or new plant varieties. These developments are needed to keep our agricultural production ahead of the demands of our growing domestic population and the food requirements of our customers and friends in other nations. Therefore, agriculture must attract outside capital if it is to continue meeting the needs of our Nation.

Many provisions of HR 13270 will have the effect of driving outside capital away from agriculture and thereby freezing our agricultural production capacity into its present pattern.

It is ironic that such changes would be proposed at this time when there is growing concern for world hunger and a greater than ever need for maximizing the agricultural productive capability of this country for the future. Unless these agricultural development efforts continue year after

year, the improvements will not be available as they are needed. As a result, our abundance may disappear and our food prices may be forced upward, sharply, as our population grows. In the Nation's interests, the Congress cannot afford to adopt changes in our tax laws which will drive outside capital away from agriculture.

Much of the same arguments can be made for the mineral and energy industries. I have before me a statement made by Mr. Andrew Fletcher, Honorary Chairman of the St. Joseph Lead Company, when he appeared before the Subcommittee on Minerals, Materials, and Fuels of the Senate Interior Committee. I would like to quote briefly from his remarks.

"The United States is a prodigious consumer of minerals and fuels. The startling truth is that we have consumed more of these resources in the last 30 years than the entire peoples of the world in all previous history. In the single decade from 1965 to 1975, it is estimated that our mineral consumption will have climbed 40 percent. Today, the worldwide per capita consumption of iron and copper is about one sixth that of the U.S., and for lead it's about one eighth. Looking further into the future, we can see that not only will our own growing appetite continue, but other nations and particularly underdeveloped nations will increase their demand at an even more rapid rate than ours.

"It is becoming somewhat trite, I know, to cite expectations about the year 2000. But it is also sobering to realize that the millenium is about as far ahead of us as the beginning of World War II is behind us. With this in mind, let's look at the statistics. Comparing the figures for 1965 and estimates for the year 2000, based on Bureau of Mines projections, we find:

- U.S. zinc consumption will increase by almost 375 percent; the worldwide total by about the same.
- U.S. lead consumption will increase by over 200 percent; the worldwide total by more than 250 percent.
- U.S. iron consumption will increase by nearly 175 percent; the worldwide total by more than twice that much.
- U.S. coal consumption will increase by over 250 percent; the worldwide total by over 575 percent.
- U.S. copper consumption will increase by over 200 percent; the worldwide total by nearly 375 percent.

"It will be no easy task to meet these soaring demands, and it is notoriously difficult to estimate the resources we will have at our command. This is not only because we cannot

foresee what geological discoveries may lie ahead. It is also because the exploitation of orebodies depends on so many factors: location, quality, technology, marketability, etc. Nevertheless, a study by Resources for the Future, Inc. has concluded that over the next three decades, the U.S. will be largely dependent on imports for such vital metals as manganese, chromium, nickel, and tungsten. More ominously, it believes that total world demand will begin to outstrip the known mining potential of copper, lead and zinc in all parts of the globe.

"Given this situation, there are those who argue that the U.S. should sharply curtail its domestic mining production, relying on imports for as long as possible and husbanding its own resources. In our judgment, this would be extraordinarily shortsighted.

"First, it is fatuous to believe that good foreign relations could survive this sort of behavior, with us carting home foreign treasure while carefully hoarding our own. This would become increasingly impossible as the rest of the world experienced a constant narrowing between supply and its own growing demand.

"Second, it would make us dangerously reliant on our present stockpiles or would call for a vast increase in those stockpiles. Moreover, once we allow mines and machinery and men to fall into disuse, it can take a long time --- in the case of a national security emergency, a perilously long time --- to restore them to productivity.

"Third, this is simply not a sound way to increase our command of mineral resources. Essentially there are only two ways to do that: either by exploration that leads to the discovery of new resources, or by developing the technologies that will permit more effective and economic exploitation of the ones we already know about.

"Exploration is no longer a matter of a lonely prospector with a pick and a mule. Today it is often a search for deeply buried deposits, requiring aerial photography; geochemical, aeromagnetic, electromagnetic, and ground magnetometer surveys; induced polarization; gravity surveys; and eventually diamond drilling or trenching. It is an expensive, arduous and frightfully risky enterprise. Even when an economically viable discovery is made,

there can ensue a long period of huge capital expenditures before the minerals can begin to flow to the marketplace. For example, it will be in the mid-1970s, after a decade of development and costs of about $200 million, before American Metal Climax, Inc. will bring its new molybdenum mine in Colorado into production.

"Besides new discovery, we can expect to increase our available resources through improved exploitation. For example, at the turn of the century the grade of copper mined in the U.S. wasaround five percent. The profitable mining of lower-grade ore has become possible only because of immense investments of capital and ingenuity. There may be unbounded riches in what we now consider dross, if we can but find a way to win its value."

As far as future needs of petroleum are concerned, Secretary of Interior Udall probably summed up the situation best in an address before the National Petroleum Council in March of 1966 when he said:

"In the case of oil, if domestic sources continue to supply approximately the same relative proportion of our total demand for liquid hydrocarbons as they now do and if we elect to hold to the historic reserve-to-production ratio at 12:1, we will have to add 83 billion barrels to our proved reserves between now and 1980. This begins with a requirement of 4.7 billion barrels for the year 1966, and ends with a need for 6.9 billion barrels for the year 1980, with a yearly average for the period of 5 1/2 billion barrels. This will not be easy. In only one year - 1951 - has the industry been able to record a gross addition of as much as 4 1/2 billion barrels of liquid hydrocarbons to its proved reserves. Of more significance, the average of the yearly additions since 1955 has been 3.3 billion barrels.

"For gas, under the same basic assumptions and choosing to maintain a reserve-to-production ratio of 18:1, we shall need to add 450 trillion cubic feet to our proved reserves. This is an average of 30 trillion cubic feet a year. At no time in its history has the petroleum industry ever added as much as 25 trillion cubic feet to its reserves of gas in any one year. The average since 1955 has been 20 trillion. The meaning of these figures becomes even more clear if we compare our recent past experience with a comparable period of time in the immediate future.

"...My point is simply that there is enough evidence at hand now to suggest strongly the need for us to consider more carefully than we have so far done, the question of how these enormous future demands for petroleum energy will be supplied."

Secretary Udall further stated to the National Petroleum Council in July 1968:

"The implications of this imbalance are for a gradual deterioration in the nation's capabilities to supply itself with crude oil. No precipitate, near-term crisis is in prospect, and the deficits could go on accumulating for several years. But it is clear that sooner or later the account must be balanced; no industry can go on indefinitely shortening its stocks in the face of a steadily rising demand for its products."

As is well known, my own State of Oklahoma has made a generous contribution to the energy needs of this nation over the years and our economy has come to depend heavily upon the oil and gas industries. The distinguished Chief Executive of the State of Oklahoma, Governor Dewey F. Bartlett, has appeared before the Committee and introduced compelling testimony relating to the critical needs of the oil and gas industry, and I do not propose to take the Committee's time to reiterate his position. I would like to emphasize and associate myself with his remarks.

These proposed changes in the tax provisions applicable to the oil industry will, without doubt, reduce the industry's incentive and ability to explore and drill. A recent study made by the Bureau for Business and Economic Research at the University of Oklahoma indicates that during a recent two-year period, independent oil producers drilled 86.5% of the exploratory wells and 20% of the development wells completed in the State of Oklahoma. In terms of the risk capital employed, the survey showed that 70% of the capital employed by independent operators is obtained from outside investors who are not connected in any other way with the independents' oil operations. Thus, it is clear that the independent oil producer in the State of Oklahoma relies heavily on outside investment funds as a source of capital to supplement his own funds obtained through capital recovery. Anything that will adversely affect the value of the ventures considered by the oil operator will also adversely affect the ability of the operator to attract the capital needed to continue drilling for new oil. If this results in a reduction in the activities of the independent oil operators as a group, it will have an adverse impact on the economy within which he operates.

The degree to which changes in tax legislation will affect the economy of the State depends upon the changes themselves. If the current write-off of intangible drilling costs is restricted and the proposed reduction in the depletion allowance to 20% is carried out, the survey to which I referred indicates that the drilling operations of independent oil producers in Oklahoma might be reduced by as much as 45%.

I have concentrated on the provisions in the House Bill and the Treasury proposals which affect domestic oil operations, particularly those of the independents. With respect to the foreign area I certainly support the Treasury in urging that Section 501, which would eliminate depletion on foreign oil and gas production, be deleted.

In considering the Tax Reform Bill of 1969, I feel that the key point, as it relates to the mineral, fuel, and agricultural industries is whether or not this Nation wishes to maintain a strong position of self-sufficiency in these vital areas. If it is the determination of the Congress that we want our Nation to become dependent upon imported minerals, fuel, and food then there could be justification for some changes proposed by HR 13270. If, on the other hand, we desire our Nation to be well fed with a reserve to be shared with other nations, if we desire a dependable low-cost source of energy from domestic sources for the citizens of our urban centers, and if we desire to have available on this continent the sources of the minerals which are vital to our industrial society, then there is need to attract capital into the development and operation of these economically hazardous occupations. Present tax laws provide such incentives. They must be retained and strengthened.

I do not wish to offer myself as an expert on tax matters. I recognize that many of the distinguished members of this committee have devoted much of their careers in government to study our tax matters, and that in addition, they have the counsel of highly qualified members of congressional staffs and governmental departments. However, I would like to suggest one possibility, so far as helping this Nation retain a strong supply position in minerals and fuels. As many of you know, I am a land owner, and if I sell a portion of my land, our present law allows me to treat the income as the sale of a capital asset and to pay taxes under the terms of our capital gains law.

On the other hand, if the owner of an ore body sells a quantity of the ore, he must show the income from this source as current income and pay tax after deducting a certain amount for "depletion allowance."

Over the years the depletion allowance, particularly as related to the petroleum industry, has come under sharp and in many cases totally unjustified attacks. As has been stated here, these depletion allowances have not been excessive, since reserves of both minerals and energy sources have not kept up with our growing needs. Additional incentives are needed. I believe one way they could be provided would be for the Congress to pass legislation providing that the sale of mineral, or petroleum production be treated as the sale of a capital asset and taxed under the terms of our present capital gains laws. I would suggest that the depletion allowance be left at the present level and that the above approach be allowed as an option.

As a former Governor of the State of Oklahoma, I am fully aware of the growing needs of state and local governments, and I know from first-hand experience how many of these needs for additional services and facilities are met with funds made available by the sale of tax-exempt municipal bonds. Our own State of Oklahoma and its many sub-divisions could not come close to meeting our needs for hospitals, sewers, water systems, highways, airports, educational facilities, and many other necessary governmental services without the frequent sale of municipal bonds. Such sales would become virtually impossible under the provisions of HR 13270, and I would like to add my voice to the others you have heard opposing these changes.

As I said in the beginning of my statement, I strongly favor the passage of "tax reform legislation." There is great need for such legislation and a great impatience among the citizens of this country for more equitable and less complex tax law.

SUMMARY OF TESTIMONY BY
SENATOR CHARLES McC. MATHIAS, JR.

SUBMITTED TO THE
SENATE COMMITTEE ON FINANCE
OCTOBER 2, 1969

I. PHILANTHROPY: H.R. 13270 is a severe challenge to spirit of philanthropy. Reported abuses of tax exemptions justify better oversight and auditing but not a wholesale assault on the voluntary sector.

A. Limit on charitable deductions should be raised to 50 percent of adjusted gross income as in H.R. 13270. Administration's recommendations on charitable trusts and gifts of appreciated property are substantial improvements over House bill but more modifications should be considered. Gifts of appreciated property to foundations should not be in separate, prejudicial category.

B. In regard to foundations:

1. Proposed tax on investment income should be reduced to 2 percent, as recommended by the Administration, and explicitly imposed as a user charge or fee to defray auditing programs.

2. Provisions requiring 5 percent yield are unrealistic and could be mischievous. More flexibility should be permitted.

3. Stock ownership limitations of H.R. 13270 would impose real hardships on private foundations whose assets consist of stock in closely-held family corporation and whose major contributors are family members. If attribution rules remain so broad, such foundations would have to dispose of all such stock even if non-voting stock. Legislative mechanisms are needed to permit redemption by the issuing corporation in such cases without adverse tax effects to the foundation, the corporation, its stockholders or the original donor of the stock.

4. Rules restricting foundations' activities in public policy fields should be clarified and rationalized.

II. STATE AND MUNICIPAL BONDS: H.R. 13270's proposals have already caused chaos in the bond markets. Congress should not make

any changes which would increase difficulties for state and local governments in financing needed capital improvements.

III. PENSION PLANS AND DEFERRED COMPENSATION:

A. Present tax treatment of lump- sum distributions from qualified pension plans should not be changed.

B. As recommended by Secretary Kennedy, changes in tax treatment of deferred compensation plans, proposed in sections 331 and 541 of H.R. 13270, should be dropped pending further study of overall economic impact.

IV. LIVESTOCK: Proposed changes in capital gains treatment of income from sales of livestock would create havoc in an industry already beleaguered with economic problems.

STATEMENT OF

SENATOR CHARLES McC. MATHIAS, JR.

SUBMITTED TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 2, 1969

Mr. Chairman, it has been said that a real opportunity for tax reform comes only once to each generation. If this is true, this is our opportunity and we must use it well.

H.R. 13270 is undoubtedly the most far-ranging bill we shall consider this year. As the mail pouring into our offices testifies, there is great public concern over the growing weight of taxation -- Federal, state and local -- on the nation's wage-earners. As the mail also indicates, each section of this bill will have a lasting impact on some segment of our economy and society. Thus our task is the difficult one of balancing general concepts and specific complaints, and producing an equitable and durable bill.

I claim no special expertise across the whole spectrum of taxation, and I would therefore like to confine my remarks today to four areas which are of deep concern to me and to many Marylanders: philanthropy, state and local bonds, pension plans, and livestock. I choose these subjects not out of any limitation of interest and concern, but out of a limitation of your time.

I. CHARITABLE CONTRIBUTIONS AND FOUNDATIONS

The House-passed bill constitutes a severe challenge to the philanthropic activities which have been a uniquely American asset throughout our history. As far back as the 1830's, Alexis de Tocqueville noted the tendency of Americans to form voluntary associations to meet public needs. This week the launching of annual United Givers Fund campaigns across the nation reminds us again of the tremendous contributions which the voluntary sector has made to our social health and national welfare.

The spirit of philanthropy has built and sustained many of our greatest educational and medical institutions. It has founded and supported many of our finest libraries, museums and orchestras. It has enriched our cultural life and underwritten many valuable community services, such as scouting and the Red Cross, which otherwise would have to be provided by government or not at all.

Private foundations have been a vital expression of this philanthropic spirit. As HEW Secretary Robert Finch wrote

recently:

> In every area of thought and action -- in all the arts and sciences, in basic research, in public health, in scholarship and creativity, in the building and preserving of independent social institutions -- the catalogue of foundation-supported efforts provides many benchmarks in the progress of recent civilization.

It is true that a few individuals have used charitable contributions or created foundations to reduce their tax burdens excessively. Also, a few foundations have abused their tax-exempt status. Such excesses do justify improvements in the laws and far more extensive oversight and auditing of tax-exempt activities. But they do not justify, in my judgment, a wholesale assault on the voluntary sector -- especially at a time when government's social burdens are already vast, or when diversity and innovation should be promoted rather than squelched.

A. In regard to charitable contributions, therefore, I support the House provision which would increase the limit on charitable deductions from 30 percent to 50 percent of adjusted gross income. I am concerned, however, about other provisions of the House bill which could discourage very large contributions, the creation of charitable trusts, and gifts of appreciated property, including works of art and literature. The Administration's recommendations to this Committee represent a substantial improvement over the House bill, but further modifications should be considered.

In particular, I cannot understand any justification for placing in a separate and prejudicial category gifts of appreciated property to private foundations as opposed to similar gifts to other types of tax-exempt entities.

B. In regard to foundations, I am especially troubled by four aspects of H.R. 13270:

1. The proposed tax of 7½ percent on the investment income of foundations is to me excessive and unwarranted. I therefore support, as a compromise, the Administration's recommendation to reduce this to 2 percent. To maintain the traditional tax-exempt status of foundations and other philanthropic institutions, moreover, I believe that such a levy should be clearly and explicitly imposed as a user charge or fee,

earmarked to defray the administrative expenses of auditing and examining exempt institutions. Such an approach would support a fully adequate IRS auditing program. It would also avoid encouraging states and localities to follow the Federal lead by attempting to tax this one portion of the universe of tax-exempt institutions.

2. The "income equivalent" provisions requiring a minimum 5 percent yield for foundations is unrealistic and could be mischievous. Foundation managers are obliged to maintain a prudent investment portfolio which would, presumably, include a mixture of growth and income-producing investments. The House bill would upset this management concept and could lead foundation managers to chase the vagaries of the stock market in pursuit of a 5-percent return, rather than concentrating on their philanthropic responsibilities. Far more flexibility should be permitted.

3. The stock ownership limitations of section 101 of H.R. 13270 would impose special hardships on private foundations whose assets consist wholly or primarily of stock in closely-held family corporations, and whose major contributors are members of that family. Even where these holdings are of non-voting stock, the extremely broad attribution rules of the House bill would require such a foundation to dispose of all its securities in the family corporation, because of the stock held by family members. Presumably the funds received in return would then be reinvested by the foundation in other securities not subject to the 20-percent limitation.

I am not convinced of the necessity for such complete divestiture where the stock involved is non-voting stock. However, I am more concerned by the fact that in such cases, compliance with these provisions would be extremely difficult since no ready market would exist for the non-voting stock other than the family or the issuing corporation. Realistically,only redemption by the issuing company would provide the foundation with a reasonable value for the securities held.

While the House bill does not forbid such redemption by the issuing company, the Internal Revenue Service has sometimes taken the position that where a corporation redeems shares which have been received by a foundation as a gift, the redemption amounts to a dividend taxable to the persons who made the gift. As far as the redeeming corporation is concerned, there is a possibility that the IRS would assert the penalty tax for unreasonable accumulations of income. The uncertainty of this situation is extremely dangerous and could effectively prohibit redemption as a practical matter.

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At the very least, therefore, an explicit legislative mechanism should be provided to allow redemption by the issuing company in such cases over the 10-year period with no adverse tax effects to the foundation, the redeeming corporation, its stockholders or the original donor of the stock involved. In related areas, too, I would encourage this Committee to provide the required assurances to permit such foundations to comply in good faith with the concept of divestiture without incurring penalties for their compliance.

4. Finally, I urge this Committee to clarify the highly confusing and ambiguous language of the House bill restricting the permissible activities of foundations in public policy fields. The line between lobbying and educational activities is a delicate and elusive one, but -- as Secretary Finch has stated -- a rational definition must be found. It would be a real mistake, I feel, to discourage foundations from sponsoring innovative efforts in education or medical research, or to deny legislators and public administrators the benefits of the experience and knowledge of many eminent Americans simply because those individuals are connected with foundations. For example, under some interpretations of the House bill, public officials could discuss the Heller-Pechman revenue-sharing proposals with Dr. Heller, who is at a university, but not with Mr. Pechman, who is associated with a foundation. Such inane situations should be precluded by clarification of these provisions.

II. STATE AND MUNICIPAL BONDS

A second area of special concern to me is the proposed change in the treatment of interest on previously tax-exempt state and local bonds.

In 1968, $16 billion in such bonds was issued to finance a portion of the vast capital needs of our nation. The tax bases on which state and local governments depend are already overburdened. In this context, I believe we should be extremely cautious in considering measures which could make it even more difficult for states and localities to finance much-needed improvements such as schools, hospitals, streets, libraries, and water systems.

The mere discussion in Congress of removing the traditional exemption from these bonds and of including such income in the LTP and allocation of deductions provisions has engendered chaos in the market. In the period from February to August 1969, the Bond Buyers' Index of 20 representative municipals rose from

5.04 percent to 6.02 percent, a considerably larger jump than occurred in federal and corporate debt financing. As our colleague from New York pointed out before this Committee, the market rate of return on state and local bonds has been steadily rising. It would appear that the revenue effect of the proposed changes may not be great, but that the market effect could be catastrophic.

If we are to design a true tax-reform measure, we must not force local governments to abandon bonds and turn to increases in regressive sales, property and utility taxes.

Protracted litigation to test the limits of the doctrine of "intergovernmental immunity," regardless of the eventual outcome, promises to keep the municipal market in confusion for years if changes similar to those in H.R. 13270 are ultimately enacted.

Federal grants-in-aid for capital purposes in F.Y. 1970 will total some $6.5 billion. The bulk of the required matching funds will be raised through bond issues. As the Federal government holds out promises of revenue sharing, a mass transit fund, and welfare reform on the one hand, it must not seriously erode a significant source of state and local government financing on the other.

III. PENSION PLANS

Since 1942 lump-sum distributions from qualified pension plans and similar sources have been accorded capital gains treatment. The House bill would prospectively limit such treatment to the amount in excess of employer contributions.

The fact that these distributions involve receipt in one year of funds accrued over a number of years suggests that the entire amount should continue to be taxed at special rates. I am confident that this Committee will carefully examine the relevant portions of H.R. 13270 to insure that the reasonable expectations of the numerous employees participating in such plans are not thwarted.

I am concerned that other changes in pension treatment called for in H.R. 13270 may have broader ramifications than initially appear. Future growth in the private sector of our economy is dependent upon the availability of a large pool of capital which will enable older businesses to expand and new ventures to be created. Any narrowing of this pool of capital should be regarded with concern if we are to keep what will soon be a trillion-dollar economy growing in a healthy manner. Profit-sharing and pension

funds have increasingly become important sources of capital for investment in the private sector.

Before any further limitations are placed on deferred compensation plans, considerable study should be given to the effect of such limitations upon this pool of investment capital. I therefore endorse the request of Secretary Kennedy that changes in deferred compensation plans proposed in Section 331 as well as in Section 541 (referring to subchapter S corporations) be dropped from the bill for further study.

IV. LIVESTOCK

Finally, I am concerned about proposed changes in present capital gains treatment of income from the sale of livestock. Lengthening the required holding period and including livestock in the depreciation recapture rule could create considerable havoc in an industry already beleaguered with economic problems. Here, as in the case of foundations, we must avoid penalizing the vast number of legitimate operations to reach alleged abuses by a small number of taxpayers.

Mr. Chairman, in conclusion, I wish to congratulate you and this Committee and its staff for the intensive scrutiny you are giving to this massive bill and the hospitality you have shown to all witnesses. I look forward to working with you toward the enactment of tax reform legislation which will promote the interests of tax equity and our national economic health.

# # #

For Release on Delivery
October 2, 1969 a.m.

Statement on H. R. 13270
Senate Committee on Finance
October 2, 1969
Dan Throop Smith

Mr. Chairman and Members of the Senate Committee on Finance:

It is a pleasure and honor to have this opportunity to appear before you with reference to H.R. 13270 which would make the most extensive revisions in the tax laws since the adoption of the Internal Revenue Code of 1954. Many of the substantive revisions are long overdue. They will prevent abuses which have developed under the letter of the existing law but seem rather clearly to flout its spirit and the intent of the Congress. In that category, one may readily include the Clay-Brown provisions and the extension of the unrelated business income tax to the exempt organizations to which it does not yet apply; the tighter rules on farm and hobby losses; the prevention of tax benefits through a proliferation of multiple corporations; the tighter rules for taxation of cooperatives; the recapture of depreciation on real estate; the rules for peculiar forms of stock dividends and separate classes of common stock and the proposed limitations on certain aspects of mergers, which are discussed subsequently. The reasons for the foregoing changes are all well stated in the Report of the House Committee on Ways and Means.

Other substantive provisions represent new departures, some of which seem unduly complicated and questionable from the standpoint of economic or social policy.

State and Municipal Bond Interest

The proposal for an option to states and localities to issue taxable bonds, with a Federal interest subsidy which would more than offset the higher

interest costs, is the best approach thus far devised to deal with a problem which each year becomes more perverse in its effects. The issues of state and local bonds have become so large that they can be absorbed only by offering yields which do not reflect their tax advantage to most holders. The interest savings to borrowers are far less than the revenue losses to the Federal government; under the proposed new procedure both levels of government would be better off, a distorting element in the flow of investment funds would be removed and the highest-bracket taxpayers would no longer have an opportunity for a large intra-marginal tax benefit.

But any change in the treatment of municipal taxes should be made only with respect to future issues. The inclusion of municipal bond interest in the limit on tax preferences would be a form of retroactive legislation. And it has already disturbed the bond market. The Treasury recommendation to remove this item from the limitation on tax preferences should be accepted - and the sooner the better for our hard-pressed state and local governments.

Private Foundations

As regards private foundations, the prohibitions on self-dealing seem thoroughly reasonable and desirable. There have been significant abuses and the proposed constraints would not appear to hamper any reasonable objectives of foundations. The same statement seems valid with respect to the limitation on stock ownership and the use of assets, though a long period should be allowed for divestment. It should also be recognized that in a good many cases companies in which foundations hold a large interest will become vulnerable to raids by other corporations seeking mergers.

The imposition of a tax on investment income, by contrast, seems to be an undesirable and uncalled for penalty. Tax-exempt charitable and educational organizations have been a source of real strength in our society and their continued activity will help to maintain diversity in areas where there is danger

of excessive uniformity through expanded government programs. Once adopted, the applicable tax rate is likely to be increased as a response to unpopular programs financed by one or a few foundations, thereby depleting the strength of all foundations. It would be much more desirable to impose necessary restrictions directly as is done in other parts of the applicable sections and to confine any tax to a fee sufficient to cover the costs of administering returns of tax-exempt foundations as has been proposed by the Treasury.

Furthermore the line of demarcation between permitted and forbidden activities concerning legislation is too vague and would almost certainly prevent outlays on such important subjects as the population explosion and the prevention of further pollution of the environment. Some constraints are necessary, especially those related to expenditures for a particular candidate or selective voter registration, but revision in the statutory language or some very strong and clear examples of exemptions in the Committee Reports seem necessary if the country is not to lose the benefit of leadership of foundations in dealing with social problems which almost inevitably involve legislation of one sort or another. Specifically, the prohibition of expenditures "to carry out propaganda, or otherwise attempt to influence legislation" in section 4945 (b) (1), described further as "any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof" in section 4945 (c) is much too comprehensive. I repeat for emphasis that programs to alert the general public to the problems of the population explosion and the pollution of our environment would appear to be ruled out. Governments have been very slow to develop their own programs in these two most vital areas; society needs all the leadership and education it can get on subjects such as these, and tax legislation which prevents bold action would be little short of tragic.

Restricted Property

Options in restricted stock will probably not be used to any appreciable extent in the future if the proposed changes in their tax treatment are adopted. Options in this type of stock have developed in recent years to circumvent some of the limitations imposed on qualified stock options which are given special favorable treatment in the tax law. Since options in restricted stock may be used to secure more favorable tax treatment, it is not unreasonable that their value should be taxed fully as ordinary income.

Though the subject of options is controversial, there is a good deal to be said for long-term stock ownership by management in the companies for which they are responsible. Unfortunately, stock options have too frequently been abused, with quick sales as soon as stock qualifies for capital gains treatment. The present law on qualified stock options might well require a longer holding period and permit a longer period for options to run before exercise.

But the maximum marginal tax rate of 50 percent on earned income will significantly change the relative attraction of options and cash compensation for both executives and corporations in favor of cash compensation. The use of options of all sorts will probably decrease in any case, and the new provisions on options in restricted stock will turn out to be relatively unimportant.

Deferred Compensation

The 50 percent maximum marginal rate on earned income will also very substantially reduce the advantages of deferred compensation contracts. The difference in the tax rate applicable to pre-retirement and post-retirement income will be much less for executives with large salaries, and they will tend to find that the advantage of immediate receipt of income, with opportunities for immediate investment, will outweigh the advantages of postponed receipt for relatively minor tax differentials. Thus the use of deferred compensation contracts may be expected to diminish considerably.

One of the reasons for the existing revenue ruling in 1960 was to remove an annoying area of uncertainty in the tax law. There are many ways to write compensation contracts to make income payments after normal retirement appear to be related to continuing advisory services. Extensive litigation occurred and skilled tax practitioners were usually able to construct a contract which ostensibly related later payments to later years. The proposed legislation would throw into the courts again this whole subject with an advantage given to those who sought the advice of specialists. In view of the probably substantial reduction in the use of deferred compensation contracts, it seems doubtful that it would be worthwhile to recreate this area of uncertainty.

When the revenue ruling was adopted in 1960, it was feared that large established companies whose credit was unquestioned might have an unfair tax advantage over small or new companies with which a defined compensation contract would be of questionable value. There is no evidence that the ruling has had this effect and the only issue thus has become one of equity which, as noted above, will be minimal in the future. Certainty would seem to be more important than a minor refinement of equity. The Treasury recommendation to postpone action in this area is reasonable.

If legislation is adopted now, it would appear to be unreasonable to exclude deferred compensation from earned income to which the 50 per cent maximum marginal rate applies. Though compensation is deferred it is still compensation and should be treated like all other forms of earned income.

Percentage Depletion on Foreign Production

As the House Committee Report indicates, any revenue gain from the repeal of foreign percentage depletion will be eliminated in the long run by increased foreign taxes. This change in the law is thus not only pointless but actually perverse in its effects. The profits of U.S. companies will be reduced by higher foreign taxes. Our balance of payments will be hurt because there will

be smaller foreign profits to be repatriated. And to the extent that foreign countries impose higher taxes selectively on U.S. companies, American oil companies will be at a competitive disadvantage in comparison with corporations of other countries. In view of the importance of income from foreign oil operations for our balance of payments, it seems contrary to our national interest to invite other countries to put U.S. companies at a tax disadvantage. The Treasury has wisely recommended that this provision be dropped.

Capital Gains and Losses

Though the tighter definitions of capital gains are generally reasonable, the removal of the 25 per cent maximum rate under the alternative tax is undesirable and, in the minds of many people, unfair. The U.S. tax law has recognized the special status of capital gains for almost 50 years. Though the net accretion concept of income is popular in much of the theoretical writing in public finance, the distinction between capital and income is basic in corporate accounting and law, in trust law and indeed in family financial management. A family, a corporation, or a trustee which is so imprudent as to fail to recognize this distinction is headed for trouble. A government which fails to recognize the distinction, and by its tax laws encourages its citizens to disregard the distinction, seems imprudent to a high degree.

The economic and equity arguments regarding the taxation of capital gains are all familiar and need not be repeated here. The 25 per cent maximum has been in the law for many years and it seems quite inappropriate to single out this one rate for such substantial increase to 35 percent for those in the top bracket (and higher if one takes account of the surcharge). In fact, to put this rate up by 10 percentage points while reducing the maximum rate by only 5 percentage points seems extremely unfair in a bill which purports to give general relief to all income levels.

It should be noted further that the realization of a capital gain is an indefinitely postponable act. Though there is no magic in the 25 per cent maximum, a large increase in the rate may so reduce transactions that it will actually reduce both revenue and mobility of capital funds.

The extension of the holding period from six months to a year to qualify for long-term capital gains treatment is appropriate; gains on short-term holdings may be expected to represent trading profits regarded as available for consumption rather than true capital appreciation embodied in an individual's capital fund. The longer holding period will probably reduce total transactions in the security markets, but it is questionable whether rapid turnover does not represent mere churning in the markets with little benefit with regard to mobilization of savings or corporate financing.

However, the extension of the holding period suggests the reintroduction of a series of steps for percentage of inclusion of capital gains. This seems reasonable both from the standpoint of equity and economic policy. As a matter of equity, the longer-term gains are more likely to be regarded as a part of one's capital, and a tax on a shift in the particular investments held thus becomes a capital levy rather than a tax on income. From the standpoint of economic effects, as noted above, short-term gains represent trading activity rather than investment, and though a certain amount of trading is necessary to assure liquidity in the market, excessive trading may involve mere churning and even lead to greater fluctuations in security prices which on balance will repel rather than induce investment.

Specifically, I urge that consideration be given to a sliding scale with a range of percentage inclusions such as:

Up to one year - full inclusion

1 - 2 years - 75 per cent

2 - 5 years - 50 per cent

5 - 10 years - 30 per cent

over 10 years - 20 per cent

With a sliding scale such as this, there would of course be no need for an alternative tax to keep a reasonable maximum rate on those capital gains which are most likely to be the capital gains in which the proceeds, net of tax, are kept embodied in capital investments.

Charitable Contributions

Some aspects of the proposed change in the treatment of charitable contributions of appreciated property seem reasonable to prevent artificially high deductions. Apparently there has been a good deal of abuse in claims of high values for art objects, with recipient museums and galleries having no adverse interest against excessive valuations. In spite of the Treasury's statement that the abuse has been brought under control by new administrative procedures, a limitation of the charitable contribution for art objects to cost would not be unreasonable nor should it, in the long run, prevent ultimate gifts to museums. Ownership by successive generations would be likely to be prevented by estate taxes.

However, this should be the only exception to the general rule of charitable deductions measured by value, without any general attempt to tax appreciation directly or indirectly. The Treasury's recommendation to remove the appreciation on contributed property from the limit on tax preferences and the allocation of deductions was most welcome. If this is not done, many educational institutions and hospitals will be badly hurt in their drive for funds. There is

little if any room for abuse through artificially high valuations in gifts of securities. The pattern of private gifts for education and charities is so important to maintain our pluralistic society that the tax laws should not be changed to curtail them.

Accumulation Trusts

The proposed new rules on accumulation trusts are exceedingly complicated. Secretary Cohen's merciful and wise recommendation that they be made to apply prospectively should be adopted to avoid the imposition of a really impossible task of reconstructing for past years the income of young people for whom no income records were kept because it was known that they would have no tax to pay. Even when applied prospectively, the task is a formidable one. To assure an accurate tax on termination of a trust, records will have to be kept for even a few dollars of income for every infant who may turn out to be the beneficiary of a trust which has accumulated income.

On various occasions, I have proposed a change in the law to deal with abuses under accumulation trusts which I believe would be both tighter and simpler than the present proposal. The alternative approach would tax income of an inter vivos trust to the grantor unless it was distributed and taxed to a living beneficiary and require the consolidation of income from all testamentary trusts and inter vivos trusts after the death of the grantor. If the proposed change in H.R. 13270 is adopted, it would seem reasonable to make it apply only to accumulations after the beneficiary has come of age by which time a young person may be expected to keep adequate income records anyway. There are many trusts established by grandparents for grandchildren with no thought of tax avoidance.

In 1954, when this Committee approved new rules permitting double personal exemptions for dependent children and their parents, one of the reasons was to prevent young people from discovering that the income tax law was irrational

and perverse in its effects at the time of their first personal contact with it. The new rule on accumulation trusts, unless modified to apply only to accumulations after a beneficiary comes of age, is likely to become a horrifying example of complexity and destroy respect for the tax law, which is the mainstay of our revenue system, on the part of another generation of young people.

Investment Credit and Amortization

The investment credit should never have been adopted and its repeal is no loss. But at the same time the reserve ratio test in the use of the depreciation guidelines should be removed by administrative action or, if that is not deemed possible, by statutory authorization. This test will place severe limitations on the use of the guidelines in the future. No other major industrial country has any similar constraints. If it is continued, the United States tax law will put U.S. business at a significant disadvantage compared to foreign competition in maintaining modern plant and equipment which is essential to increase productivity and thereby justify noninflationary wage raises, increase the real national income and strengthen our balance of payments.

The special amortization of pollution control facilities may be justified because of the overwhelming importance of the subject. But this is both an inadequate and incorrect solution to the problem. Severe fines and other penalties are necessary and appropriate. When costs are imposed on society by industrial processes which pollute the environment, those costs should be thrown back on the producers, and in the last analysis borne by the consumers of those products (or products produced by those processes), rather than absorbed by society generally. Special tax treatment in a sense shifts to other taxpayers part of the costs which should be borne by the industry and its consumers.

Corporate Mergers

A balanced judgment on the economic significance of mergers, especially the recent rapid increase of conglomerate mergers, cannot now be made. A great deal more study is necessary, and only with the passage of time can we accumulate evidence on the effects of the new large and virtually random types of acquisitions.

In many instances mergers may strengthen individual firms and increase their competitive effectiveness. New management may be provided to a small or family-dominated company and additional financing made available to a company which is too weak or too small to tap capital markets economically. Centralized staff services may permit an innovative manager to pursue ideas without being bogged down in administrative work for which he has little taste or talent. Well matched companies and individuals may develop new strengths from their complementary attributes. And the threat of a merger through a take-over may scare a lethargic management into activity.

But mergers may also reduce competition. They may lead to a dominance by financial manipulators instead of truly constructive managers. The threat of raids may divert attention from long-run growth to defensive actions. New ownership under a holding company may repel innovators and lead to a substitution of unimaginative organization men. And the capital structures of some of the new conglomerates are uncomfortably reminiscent of some of the holding company inverted pyramids of the late 1920's. When the fixed charges on new securities issued in acquisitions exceed the pre-tax income of the companies acquired it seems likely that leverage is being pushed too far, and that a tax law which discriminates against equity financing is leading to unstable financial structures.

Perhaps the most serious result of the conglomerate merger movement is the prominence it gives to the wheeler-dealer type of entrepreneur whose well-publicized manipulations confirm the worst suspicions of the many young people who are disposed to regard the business establishment as predatory. Though

there are numerous thoroughly constructive individuals in merger activity, there are a considerable number who would in fact be regarded as at best neutral, and at the worst, truly predatory under most people's standards, including the majority of business executives. The disenchantment of young people with our present economic structure is so widespread that society can ill afford to permit continuation of an aspect of business which, even though it may be minor and unrepresentative, is so prominent and distasteful to many people that it strengthens their disposition to reject the entire system.

In the absence of detailed studies on mergers, it is difficult to be sure of the soundness of the specific changes in the tax law contained in the bill. They seem reasonable, however, and if anything perhaps too lenient rather than too stringent. Certainly the denial of the installment sale provision to sales of companies in return for securities is necessary to protect the legitimacy of the concept. The very idea that such transactions could qualify as installment sales was a travesty of the principle.

General Comments on Balance of Provisions in H.R. 13270

Though many, probably most, of the substantive changes are desirable on their merits, any major tax legislation must be appraised on its over-all balance. On this basis, H.R. 13270 seems seriously deficient, as dramatically shown in Tables 3 and 6 in Secretary Kennedy's presentation to your Committee on September 4. A reduction in individual tax burdens of $7.3 billions and an increase in the corporate tax burden of $4.9 billion does not seem wise in a country which needs continuing new investment in order to increase labor productivity (and thereby make wage increases somewhat less inflationary than they have been), to strengthen our position in international competition, and help to provide funds to finance the innovations which are essential to maintain the vitality of our economy.

The distribution of tax burdens between individuals and business unfortunately may come to have political overtones. It should always be remembered that the Kennedy Administration in its first set of tax recommendations in 1961 proposed relief solely - and I emphasize solely - to encourage investment through the investment credit. Though many of us regretted that particular form of tax relief, preferring, as we did, more liberal depreciation, the wisdom of recognizing that investment is important along with consumption was notable especially when it was shown in an Administration which might have been presumed on political grounds to favor consumption. The present lack of balance, involving as it does an actual increase in taxes on the principal sources of funds for investment and on the returns from investment, is a sorry contrast indeed. It will be unfortunate if circumstances prevent the adoption of a better balance in this first tax legislation of the new Administration and the present Congress.

The adoption of a maximum marginal rate of 50% on earned income is probably the most important single change which could be made to reduce the continued search for new tax loopholes and restore an atmosphere conducive to truly productive work. The 50 per cent figure is particularly important; it has a symbolic significance in terms of an "even-break" or "50-50 partnership" in the taxpayer's relationship to his government. It is unfortunate that a similar maximum has not been set up for all income. In view of the probable redirection of efforts and removal of constraints, any revenue estimate of these changes is conjectural. The 50 per cent maximum rate may, in fact, increase revenue. Without the 50 per cent ceiling on the marginal rate of tax on earned income, H.R. 13270 would be even more seriously unbalanced.

The reasons for the 50 per cent ceiling are splendidly stated in the Report of the House Committee on Ways and Means. The same arguments apply to investment income as well. A general top marginal rate of 50 per cent would cleanse the tax atmosphere more thoroughly than any other feature of tax reform legislation.

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The net effect of the bill will be to make the tax system much more progressive than it is now, even with the 50 per cent ceiling. This result is shown conspicuously in Table 3 of Secretary Kennedy's statement of September 4. The percentage of tax relief descends steadily from the smaller to the larger incomes thereby shifting the burden to the larger incomes. And in the top bracket shown in the Table, incomes over $100,000 there is an actual increase of 4.7 per cent in total taxes! Though most of us have a quasi-intuitive acceptance of progressive taxation as fair, progession can be pushed too far and an absolute increase in taxes at the top when individuals generally are being given over $7 billions of relief seems unfair. Only the 50 per cent ceiling on earned income makes it acceptable without deep resentment.

One final point cannot be ignored in connection with any legislation making extensive changes in the individual income tax. I have saved it for the last for emphasis. The tax law has thus far included no provision relevent to the world's greatest social and economic problem - the overwhelming expansion of the population. Uncontrolled population growth has finally been recognized as leading to the doom of civilization as we know it - even to the doom of mankind. Though the tax law may now be one of the least effective ways to attempt to deal with this problem, one change could be made to dramatize its importance and in a small way reinforce other more significant approaches. Deductions for dependent children should be limited to two at a high enough income level to prevent hardship for larger families now in existence. The choice of the income level is not important. It might be $15,000 or $50,000. The important thing is to set a standard and symbolically help to refute the strange claims by some opponents of population control that it represents selective genocide or counter-insurgency. This is probably the first time testimony on tax legislation by a tax specialist has included reference to the population problem. I am sure it will not be the last. I would welcome an opportunity to develop the subject at length.

SUMMARY

Statement of George S. Koch
Council of State Chambers of Commerce
October 2, 1969

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1. If the Congress should repeal the investment credit, compensatory adjustment should be made in the tax burden on corporations through adequate rate reduction or by liberalized depreciation allowances. Such action is necessary to maintain capital investment levels needed for economic growth.

2. All reasonable and legitimate costs incurred by employees in moving to a new job assignment should be recognized in the tax provisions relating to moving expenses.

3. Present rules relating to restricted stock plans should be continued but with a provision that would prohibit issuance to employees of stock other than stock of the employer corporation or of its subsidiaries.

4. The complex provisions in the bill relating to other deferred compensation should be deleted pending completion of a current Treasury study of all deferred compensation arrangements.

5. Revisions in existing provisions relating to the foreign tax credit should be deleted and the subject should be considered in relation to the overall subject of foreign source income taxation on which the Treasury plans to submit recommendations to Congress at a later date.

6. Percentage depletion allowances have served the nation well, both as to defense and consumer costs, and have not resulted in unwarranted after-tax profits to extractive industries. Present allowances should be retained.

7. The objective of reform provisions in the bill relating to depreciation of buildings can be accomplished through the recapture provisions which would eliminate capital gain treatment with respect to all depreciation claimed in excess of straight line depreciation. Accelerated depreciation should not be denied to any facilities which are used in the trade or business.

8. Certification of pollution control facilities for rapid amortization should be limited to appropriate State authorities rather than both State and Federal. Election by the taxpayer to write off the cost in any period shorter than five years would be desirable.

9. Elimination of the 25% alternative capital gains tax and extension of the holding period to 12 months would inhibit transfers of capital and new investments and should not be enacted. The 25% capital gains rate for corporations should not be increased.

10. Both the limit on tax preferences and the allocation of deductions are moves toward taxation of individual gross income and should not be enacted. The allocation is especially onerous because it discriminates between taxpayers with the same amount of income.

11. Steep progression and existing high rates for taxation of individual incomes are the real cause of many of the problems this bill seeks to meet through a maze of complicated provisions. The new individual rate schedules and the maximum rate of 50% on earned income are commendable, but this maximum should apply to all income without distinction.

12. The taxation of interest on state and local bonds through the tax preference and allocation of deductions provisions in the bill should be eliminated. Such taxation can only add to bond interest rates and increased state and local taxes.

13. Retroactive application of several provisions in the bill is inequitable and should be modified.

STATEMENT OF GEORGE S. KOCH
On Behalf Of
MEMBER STATE CHAMBERS OF THE
COUNCIL OF STATE CHAMBERS OF COMMERCE
Before The
SENATE FINANCE COMMITTEE
October 2, 1969

My name is George S. Koch. I am an attorney-at-law in New York and am Chairman of the Federal Finance Committee of the Council of State Chambers of Commerce. Mr. Eugene P. Rinta, the Executive Director of the Council, is with me today.

We are submitting a statement of our views on H.R. 13270 and ask that it become a part of the record of these hearings. Our specific views on particular provisions of the House Bill are expressed in the statement and, because of the number of subjects on which we submit our views, I shall limit my oral presentation to a general summarization.

The Council of State Chambers of Commerce is an organization which studies and formulates views on national issues for the use of its 31 member State chambers of commerce throughout the nation. As you will note at the end of the statement, 24 of such chambers have endorsed the statement which represents a virtually unanimous consensus of our Committee. The fact that some of the member State Chambers have not endorsed the statement is primarily due to lack of time for its consideration by their policy making bodies, not disagreement with the views it expresses.

The Federal Finance Committee of the Council is composed of financial and tax oriented people from numerous business enterprises and the chambers of commerce. These men are all capable of understanding the problems of Federal finance as well as the tax law since much of their time is devoted to these subjects. From these men come expressions of deep concern regarding H.R. 13270.

Never has the membership of our Committee seen in a single tax bill so much that is in their judgment wrong for our nation.

The bill would enact the "Tax Reform Act of 1969." The key to each provision, therefore, is presumably reform. When one thinks of reform the usual impression is of improvement. The basic definition of the term in Webster's Dictionary is "the amendment of what is defective." Conceding that our income tax law contains defects, changes are not justified unless they are improvements. Our position is simply that too many of the proposals in H.R. 13270 are not improvements in the true sense and should be rejected.

In our time a new principle has emerged. It is that high income taxation is so vital a consideration of business and individual decisions that its application must be understood and be predictable. Look at the market for State and Municipal bonds. Look at the confusion surrounding the 7% investment credit. While Congress can, of course, change the tax law, such changes must be tempered by what is best for the nation as well as by an awareness of and adherence to the rules of the game. This requires a thorough understanding of how the changes will work. H.R. 13270 certainly fails to meet these principles.

One needs to reflect on the fact that the objects of the so-called reforms proposed in H.R. 13270 were passed by Congress over a long period of time. May I say that they have, by and large, been put into the law over the years because they were needed. The inordinately high graduated tax rates applicable as a taxpayer's income increases have required safety valves in order to work. Capital formation and investment are imperative in order to provide jobs so people can work and be productive. But the bill attacks the very people who provide the capital. If they are eliminated, who provides it? We can guess that only the Federal Government could do it. This is, we hope,

not what is wanted or expected, not to mention its inadequacy.

Generally speaking, we think that the tax proposals in the House bill for state and local bond interest, the oil industry, the capital formation markets, contributions to schools and other institutions, the obvious trend toward a gross income tax, the attacks on the foreign tax credit, and so on, all are wrong for the nation and our economy. Because of a few isolated and frequently misrepresented cases, the whole nation should not be penalized.

For example, the Supreme Court has ruled that the Federal government cannot constitutionally tax interest on state and municipal bonds. No doubt, this accounts for the indirect ways in which this bill attacks exempt interest. It is worth repeating that recipients of such interest do in effect pay something to the local governments involved by taking less return on their investment. Thus the local taxes on others are less. Take capital gains. Some tax systems do not treat such gains as income at all, for which a good case can be made. Then there is percentage depletion which repeatedly has been shown to be in the best interests of our nation quite aside from the fact that depletion at the existing rates is thoroughly integrated into the economics of the nation and industry so that no windfall from it can be identified except for the consumer. In the case of the recipients of donated property, great advantage to the nation and its people has resulted from the donor's giving up his property.

A curious factor pervades numerous provisions of the House bill. This is the frequent absence of any meaningful revenue effect or gain. With small, relatively insignificant revenue effect, how can these changes be justified as against the predictable serious and adverse effects on our economy that many foresee.

The bill passed by the House has a number of retroactive features which in fairness should be eliminated in any event from the final bill.

Here are some examples. The increased capital gains tax on individuals and corporations applying to increments in property accruing before the change. Such increment often is in fact nothing but inflation and does not represent real growth in value. Inclusion of state and municipal bond interest in the tax preference provisions is retroactive as to existing bonds. This is also true of the application of the limit on tax preferences and allocation of deductions to capital gains, to appreciation in donated property, to excess depreciation on real estate, and so on. Any reduction in depletion rates would inequitably apply to existing reserves and properties and thus be retroactive. Such new rates, if enacted, should apply only to reserves or properties discovered hereafter.

We urge this Committee to delay its decisions on this bill so as to provide the time needed for everyone, including Congress, the Administration, taxpayers and tax specialists, to study the bill and be more nearly certain of its effects on the economy and the nation's institutions. We would suggest that at least the balance of this year is not too much time for this purpose. Given such added time, much better legislation could be developed. What is right in fact for the nation should be right as well for political reasons.

Before concluding my oral presentation, on behalf of our Committee I wish to commend several provisions of the bill which are constructive. They include a start toward rate reduction for individuals, more realistic rules regarding moving expenses, a more equitable approach to taxing co-operatives, accelerated depreciation for pollution control items and improved income averaging.

We appreciate this opportunity to present our views to you. Our more detailed comments on specific provisions of the bill follow.

Bias Against Business in H.R. 13270

The estimated impact of H.R. 13270, when fully effective, would be a net reduction of $7.3 billion on an annual basis for individuals and a $4.9 billion increase for corporations. This shift in favor of consumption and against investment could produce serious economic consequences in the years ahead.

We submitted a statement to the House Ways and Means Committee in opposition to repeal of the investment credit, and we continue to believe that the credit should be retained. It helps to offset in part the adverse effect of inflation on capital recovery and, because of high labor costs, it or equivalent relief to corporate tax burdens is needed by American businesses to permit their competing in foreign markets. If the Congress should decide that repeal of the credit is desirable, compensatory adjustment should be made in the tax burden on corporations through adequate reduction in the tax rate or by liberalized depreciation allowance.

The Treasury has recognized the imbalance between corporate and individual tax burdens resulting from the House bill. The Secretary recommends a partial correction of this imbalance by lowering the corporate tax rate one percentage point in 1971 and an additional point in 1972 while at the same time reducing the net tax reduction for individuals. We commend the Administration for this action. But even with these adjustments the relative tax burden for corporations would be substantially greater than before the tax reductions of 1964 were enacted.

Individual income taxes were reduced 20% by the 1964 Revenue Act while corporation tax liabilities were cut 8%. This smaller reduction in corporation taxes was justified on the ground that corporations had the additional benefits of the investment credit and the new depreciation guidelines. Now it

is proposed in H.R. 13270 that the investment credit be repealed at an annual cost of $2 billion to corporations and that individual income tax rates be reduced an average of 5% in addition to other significant reductions in individual tax burdens.

We urge the Finance Committee to weigh with care the economic consequences of the shift in relative tax burdens between corporations and individuals that would be effected by enactment of the House bill in its present form.

Moving Expenses

Liberalization of existing provisions relating to employee moving expenses as provided in the bill is a step in the right direction. But the $2,500 overall limit on deduction of indirect moving expenses is not realistic when the sale and acquisition of homes are involved and on foreign moves.

In our view the reimbursed costs of employee transfers are in no sense economic income to the employee and, consequently, should not be subject to income tax. In recognition of this fact, and because all but the "bare bones" expense reimbursements are now taxed to the employee, some employers provide an additional reimbursement to cover the employee's income tax on the basic reimbursement. Many employers, however, do not and may not be able to absorb this extra cost of employee relocations.

We believe it is only fair and proper that all legitimate costs incurred by new or existing employees in moving to a new job assignment be recognized in the tax provisions relating to moving expenses. Where the employer reimburses the relocated employee for loss in connection with sale of his home by reason of the job transfer, the reimbursement should properly be considered as a capital transaction rather than ordinary income.

We fail to see why a dollar limit should be included in any improvement

in this area. Limiting the recognition to legitimate or normal items should suffice.

Restricted Stock Plans

Existing provisions relating to these plans provide for taxation of the stock only when the restrictions upon its sale, or other restrictions, expire. The value of the stock when received by the employee is treated as ordinary income and appreciation in value to the time the stock is sold is treated as capital gain. Under the bill a tax is imposed when the employee receives the stock unless it is subject to substantial risk of forfeiture. In the latter case a tax at ordinary rates is imposed when the stock becomes nonforfeitable. Present rules should be continued, but with a requirement that would prohibit issuance to employees of stock other than stock of the employer corporation itself or of its subsidiaries. This will ensure an ownership as well as employment interest of the employee in the employer company and so meet the basic purpose of the plan.

The Treasury has recommended that the highly complex provisions in the bill relating to other deferred compensation be deleted pending completion of a current Treasury study of all deferred compensation arrangements. We support this recommendation.

Foreign Tax Credit

Inasmuch as the Treasury plans to submit comprehensive proposals to Congress relating to the U. S. taxation of foreign source income, revisions in existing provisions relating to the foreign tax credit should be deleted from the bill. The foreign tax credit should be considered in relation to the other proposals on taxing foreign source income which will be submitted by the Treasury. Any urgency for action on the credit at this time is not apparent. In any event the provisions of the House bill do not conform to the basic reason

for the foreign tax credit, which is to avoid double taxation.

Natural Resources

Depletion allowances have served the nation well as an incentive for exploration and development of oil, gas, and mineral resources. Because of depletion, the availability of these resources has been far greater than would have been the case without depletion. The greater availability and supply has been an important defense asset and has held down costs to the consumer. There is no evidence that the petroleum or other extractive industries have been earning unreasonable after-tax profits. Instead, their net earnings on investments are in the same range as that of manufacturing companies generally. For these reasons the reductions in depletion allowances provided in H.R. 13270 should be deleted. Moreover, the present oil development incentives of depletion and intangible drilling expenses should not be penalized by the LTP and allocation of deductions provisions.

Real Estate Depreciation

The provisions in the bill revising depreciation of buildings is an example of a broad sweep approach in attacking a special problem related to investments in rental properties. In response to persistent complaints from the business community about the inadequacy of depreciation allowances, Congress in the 1954 Revenue Act liberalized depreciation for buildings as well as for machinery and equipment. Now in order to close the door to use of these provisions by high income investors in real estate ventures, the House bill would eliminate the accelerated depreciation provisions of 1954 with respect to all buildings except new residential housing. If we can accept the reduction of construction activity that would result, it would seem that the objective of the reform in this area could be fully accomplished through the recapture provisions in the bill which would eliminate capital gain treatment on

the sale of real estate to the extent of all depreciation claimed in excess of straight line. In no event should present accelerated depreciation be denied to any facilities, owned or leased, which are used in the trade or business.

Cooperatives

The provisions tightening up on the taxation of cooperatives are an improvement over present law. However, the pay-out provision requiring payment in cash on patronage allocations over a 15-year period is unduly liberal.

Pollution Control Facilities

Accelerated amortization of pollution control facilities, as provided in the bill, is highly desirable because such facilities do not ordinarily contribute to efficiency of production. The House provision allowing five year amortization could be improved by permitting election by the taxpayer to write off the cost in any shorter period. The certification that would be required to permit rapid amortization should be limited to appropriate State authorities, rather than both State and Federal, so that certification would be more expeditious and less cumbersome.

Income Averaging

Changes in present income averaging provisions in the bill are a significant improvement and simplification. While these new provisions should be adopted, with possible additional improvement in the Senate, the Treasury should continue to study the matter with the objective of still further improvement and simplification.

Capital Gains

In our testimony before the House Ways and Means Committee on April 2, 1969, we urged that no action be taken with respect to capital gains taxation that would tend to impair the savings and capital formation that will be needed in increasing amounts for job creation and more efficient production in

the years ahead. We pointed out that special treatment of capital transfers, as distinct from income, serves several important purposes.

First, the present special treatment of capital gains recognizes the distinction between capital and income, and it helps to preserve and expand the former so that the latter can continue to grow. It provides incentives for savings and investment which are basic to economic growth, and it helps to channel investment to the best uses of resources by encouraging mobility of capital. Finally, it is partial recognition that the appreciation in many assets sold is largely, if not wholly, the result of inflation rather than true increase in value.

The House bill, however, adversely attacks present treatment of capital gains in several provisions. These include elimination of the 25% alternative tax for individuals, extension of the holding period to 12 months from the present 6 months, inclusion of one-half of net long-term capital gains as a tax preference item, and increasing the capital gains rate on corporations from 25% to 30%. The Treasury has recommended that the provisions eliminating the 25% alternative tax and extending the holding period be deleted from the bill. We certainly concur with this recommendation. But we further recommend that the corporation capital gains rate be retained at 25% and that one-half of capital gains not be included as a tax preference item if Congress should enact provisions for allocation of deductions.

The bill would also eliminate capital gains treatment for the employer-contributed portions of lump-sum distributions from approved pension, profit sharing, and savings programs. It appears from the Ways and Means Committee report on H.R. 13270 that an important consideration in the Committee's action was its understanding that the present provision is of primary benefit to taxpayers with incomes in excess of $50,000. While we do not agree that this

is a valid reason for the change, we point out that this is a gross misunderstanding. The fact is that the provisions can and do benefit very large numbers of employees at modest as well as higher income levels, as testimony submitted to your Committee by employers clearly indicates.

The House provision would adversely affect all employees who look forward to a lump-sum payment upon retirement. Even though the special 5-year averaging provision might provide for an eventual refund, the amount would be unknown and, in the meantime, the taxpayer would be deprived of the use of his money. The present capital gains treatment was adopted originally to provide a fair averaging method which has the advantage of being positive and immediately known, as well as being fair. The House bill would create impossible problems for most retirees. For these reasons and because of the relatively insignificant revenue effect, we urge that the present treatment of lump-sum distributions be continued.

Limit on Tax Preferences and Allocation of Deductions

Two related provisions in the bill--limit on tax preferences and allocation of deductions--are designed to reduce the tax benefits which are now available from certain so-called tax preferences. These preferences include tax-exempt State and local bond interest, one-half of net long-term capital gains, appreciation in property donated to charity, depreciation claimed in excess of straight-line depreciation, and farm losses under certain circumstances. Both the LTP and the allocation of deductions are a move toward taxation of individual gross income and should not be enacted. The allocation of deductions provision is especially onerous because it discriminates between taxpayers with the same amount of income.

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Maximum Tax on Earned Income and Individual Income Tax Rates

Limiting taxation of earned income to a maximum of 50% and the new individual rate schedules proposed for all income both are commendable. They move in the direction of lessening the impact of the steep progression of the deadening present income tax rate schedule. Existing high rates are the real cause of many of the problems this bill seeks to meet through a maze of complicated provisions. We suggest that the maximum rate on all income without distinction should be 50%.

State and Local Bonds

Interest on state and local bonds should not be subjected to Federal income tax. The House bill does not provide specifically for taxing such interest but it does indirectly by including this interest as a tax preference item in both the 50% limit on tax preferences and the allocation of deductions provisions. Thus interest on presently outstanding state and local bonds, as well as future issues, would be taxed when the taxpayer's tax preference items including such interest exceed 50% of total income as a result of the LTP. Further, when the taxpayer's preference items exceed $10,000, his interest on state and local bonds will contribute to a loss of deductions under the allocation of deductions provision.

It is obvious that the unprecedented needs of state and local governments for debt financing will continue to grow in the years ahead. Even under the best of circumstances, including the present exemption of bond interest, the financing problems of these governments will be substantial. Clearly, the provisions of the House bill affecting exempt interest will aggravate their problems. In addition to the direct adverse impact that these provisions will have on interest rates of state and local bonds, the fear on the part of investors

that the exemption may be further eroded by future Congressional action will add to interest costs. The end result can only be increased taxes at the state and local levels to cover the higher financing costs.

The Treasury has recommended deletion of state and local bond interest as a preference item in the LTP provision but supports its inclusion in the computation for allocation of deductions. We urge its deletion from both.

Retroactivity

The bill in several instances in effect calls for retroactive application of proposed changes. Such retroactivity is objectionable and inequitable, and should be eliminated. Among the major provisions in which retroactive application is involved are the following: application of increased capital gains tax on individuals and corporations to appreciation in property accruing before the change in tax rate; inclusion of exempt interest on presently outstanding bonds in the limit on tax preferences; application of the LTP and allocation of deductions to prior appreciation in property sold or donated; and application of reduced depletion rates to existing reserves and properties. No doubt there are other significant instances of retroactivity in the bill.

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(See following page for list of State Chambers of Commerce which have endorsed this statement.)

The following State Chamber organizations have expressed basic agreement with Mr. Koch's statement:

Alabama State Chamber of Commerce
Arkansas State Chamber of Commerce
Colorado Association of Commerce & Industry
Connecticut State Chamber of Commerce, Inc.
Delaware State Chamber of Commerce, Inc.
Florida State Chamber of Commerce
Georgia State Chamber of Commerce
Idaho State Chamber of Commerce
Indiana State Chamber of Commerce
Kansas State Chamber of Commerce
Kentucky Chamber of Commerce
Maine State Chamber of Commerce
Montana Chamber of Commerce
New Jersey State Chamber of Commerce
Empire State Chamber of Commerce (New York)
Ohio Chamber of Commerce
Pennsylvania State Chamber of Commerce
East Texas Chamber of Commerce
South Texas Chamber of Commerce
West Texas Chamber of Commerce
Virginia State Chamber of Commerce
West Virginia Chamber of Commerce
Wisconsin State Chamber of Commerce
Michigan State Chamber of Commerce

In endorsing Council statements, such as this one, dealing with many issues and considerable technical detail, the member State Chambers reserve the right to take exception in one or more particulars.

The Connecticut State Chamber wishes to be recorded on the percentage depletion question as supporting adequate depletion allowances to assure essential supplies of oil and gas for energy purposes, but without specifying the appropriate percentage allowances.

The Delaware State Chamber had not resolved a position on the natural resources issues discussed in this statement.

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STATEMENT OF

COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC.

Concerning H. R. 13270

The Tax Reform Act of 1969

Prepared for Presentation at a Hearing of the
Committee on Finance
United States Senate
Washington, D.C.

By

Stanley Nitzburg
Tax Counsel

October 2, 1969

SUMMARY OF PRINCIPAL POINTS

1. Tax incentives are not "loopholes" but a proper part of the socially and economically justifiable dynamics of a free enterprise system.

2. Raising corporate taxes and reducing incentives for technological advancement and new plant construction adds to the competitive burden of United States business with foreign trade and will aggravate our trade and payments problem.

3. Tax relief will be attained through tax reform. Tax reduction at this time is an inappropriate response to continued inflation.

4. Our inequitable and complex system of taxation requires both reform and simplicity.

5. APPROVE §121 restricting business activities of tax-exempt organizations by subjecting their unrelated business income to tax at ordinary corporate tax rates.

6. APPROVE §231 which would liberalize deduction of moving expenses, but DISAPPROVE unreasonable dollar limitation imposed.

7. DISAPPROVE §301 which would restrict the amount of tax preference income which an individual could earn without being subject to tax.

8. DISAPPROVE §302 which requires the allocation of expenses between taxable income.

9. APPROVE §311 which would liberalize income averaging by reducing the qualifying percentage to 120% and by including capital gains in the computations.

10. DISAPPROVE §331 which would impose an additional "minimum tax" on deferred compensation payments.

11. DISAPPROVE §401 which would penalize small business by changing the tax treatment of multiple corporations.

12. APPROVE §412 which limits the application of the election to have an installment sale.

13. DISAPPROVE §413 which requires a pro-rata portion of original issue discount to be included in a bondholder's annual income and requires a corporation to file an information return recording the amount of discount earned by each bondholder.

14. DISAPPROVE §414 which limits the deduction paid by a corporation on repurchase of its convertible securities.

15. APPROVE §421 which restates the existing law making stock distributions taxable where the stockholders not accepting cash or other property receive a proportionate corporate interest.

16. DISAPPROVE §461 which would increase the alternative capital gains rate for corporations from 25% to 30%.

17. DISAPPROVE §515 which would eliminate capital gain treatment on total distributions from qualified plans made to an employee in one year.

18. DISAPPROVE §521 which eliminates the use of the double declining balance and sum of the years digits methods of accelerated depreciation on new buildings but APPROVE the provision encouraging rehabilitation of low-income housing.

19. APPROVE §§801-804 which would afford tax relief to individual taxpayers with a reservation as to fiscal soundness of enacting such provisions at this time.

20. DISAPPROVE all provisions of the bill which would have retroactive application.

Statement of
COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC.
CONCERNING H.R. 13270
PREPARED FOR PRESENTATION AT A HEARING OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D. C.
BY STANLEY NITZBURG, TAX COUNSEL
October 2, 1969

Commerce and Industry Association is the largest service chamber of commerce in the United States. Its more than 3,500 members represent a true cross-section of American business and industry both as to size and nature of enterprise.

We commend the effort that produced the Tax Reform Act of 1969 (H. R. 13270). Tax reform has been too often neglected, to difficult to face, and virtually impossible to effect. It should not, however, be attained by sacrificing other equally commendable objectives of government or by disavowing basic principles inherent in our economy.

The 1968 Republican Party platform stated the "imperative need for tax reform and simplification". The 1968 platform of the Democratic Party promised the elimination of corporate and individual preferences "that do not serve the national interest". H. R. 13270 meets neither objective. The ingeniously complex formulae and interrelated provisions contained in the bill are virtually incomprehensible and can only result in taxpayer confusion and administrative headaches. The restriction and repeal of so-called "loopholes" may satisfy public clamor, but such action does not take into account the effect on the national economy.

Incentives Are Not "Loopholes"

The capitalistic system we know, has made this country a world leader in social and economic achievement. It will sustain our continued effort to eliminate poverty and raise our national standard of living. Such a system must allow and encourage the accumulation, investment and reinvestment of capital. Such a system

must encourage individual initiative, creativity and work, providing a higher reward for the greater accomplishment. Our tax laws often encourage and support some of these activities.

Enforcement of private investment and private philanthropy is clearly preferable to expanded government activity. Accelerated depreciation, the investment credit and other tax relief provisions now under attack, actually provide the impetus for new plants, technological improvement and expanded productivity at reduced cost. This is essential for real growth and is the cornerstone of our vitality. Such provisions do not constitute "loopholes". They are the safety valves on high tax costs and a proper part of the socially and economically justifiable dynamics of a free enterprise system.

Aggravating Our Trade and Payments Problem

The pending legislation is politically expedient rather than economically sound. Shifting the individual's tax burden to corporations will have a short-lived beneficial effect. The prosperity of this nation cannot be fragmented. Labor cannot prosper unless business prospers, and the prosperity of business is not determined solely by its ability to sell in domestic markets. International trade must be in balance for true economic growth to take place, and the balance has been askew.

The primary reason for United States business having less of a share in world markets is simply the higher price of our products. Cost increases in the form of exorbitant wage rises has been a major contributing factor. Contracts with wage increments of more than 30% over three years are no longer rare and 60% hikes have been won by building trade unions.

Higher tax costs and inadequate inducements to export are other factors. Yet this bill raises corporate taxes, reduces incentives for technological advancement and new plant construction and in other respects adds to the competitive burden of business. In doing so the bill intensifies the pressure on rising prices.

Higher priced United States goods will be less welcome in foreign markets while the domestic market will be inundated by imports. The aggravated imbalance of trade will result in a new spate of demands for remedial legislation. Corrective legislation cannot be effective so long as the source of the problem is ignored, namely, higher costs due to higher wages and lost tax incentives.

The existing incentives are inadequate and should be expanded rather than restricted. This was the conclusion reached in a study published by the Department of Commerce:

> "Increasing the investment tax credit from 7 to perhaps 14 percent either for trade-sensitive industries or for all industries would provide a powerful added incentive to modernize manufacturing plants and could significantly increase U. S. competitiveness in international trade both on the import and export sides. Such a step, however, would have to be carefully weighed against the loss of U. S. tax revenue and other economic considerations, and might be put forward when tax reduction becomes possible. If, however, the U. S. trade balance continues to worsen, the proposal should be given urgent consideration." (U.S. Department of Commerce, "A Five Year Outlook With Recommendations for Action", April, 1969, p. 76.)

Tax Relief Through Tax Reform Not Tax Reduction

The need for tax relief at both the individual and corporate level is inappropriately achieved at this time by tax reduction. Tax relief will be attained by true tax reform. Reform, however, does not call for the repeal of incentives. It demands the elimination of abuses and distortions of the intended purpose of existing provisions. It demands reestablishing the statutory broad tax base and the consistent application of effective rates. This will in turn produce tax relief in that tax revenue will be maintained, if not increased, and the tax burden will be properly distributed.

The case for tax reduction at this time is based on emotionalism. It is unquestioned that net income after taxes buys less today than it did five years ago, but this is the result of inflation and not of higher taxes. The Revenue Acts of 1962 and 1964 reduced tax rates for individuals. Except for

the surcharge, the rates have remained the same and the amount of tax has been a stable cost in the taxpayer's budget.

The family budget can only be brought back into balance by the successful continuation of the fight against inflation. This bill attempts to check inflation by extending the surcharge, repealing the investment credit and imposing restrictions on accelerated depreciation. It inconsistently fuels inflation by contributing new money to the flow of commerce in excess of the amount generated by all the restraints and so-called reforms combined. Clearly, curtailment of capital expenditure by business while stimulating consumer spending can only result in continued inflation and crisis.

Although Congress is appropriately responsive to demands of the electorate for tax reform, it is inappropriate to accept a demand for tax reduction which cannot be enacted if we are to have fiscal integrity. Increased spending and reduced taxes are incompatible and cannot be achieved. If taxes are reduced, government spending at present levels cannot be sustained without creating another monetary crisis. The Viet Nam conflict still takes its toll in human and financial resources and, even with the surcharge in effect, a balanced budget is hard to maintain. Federal programs of proven value have been curtailed because of insufficient funds. New and innovative programs to cope with long-standing domestic problems have been shelved because revenue is lacking. This is reality.

Tax reduction is wishful thinking and not today's reality. The people of this country are mature enough to accept in government the same responsibilities they accept in their own households, namely, sound budgeting and fiscal integrity. Borrowing affords only temporary relief before it adds to the burden. At the national level the annual interest expense to carry debt is in excess of $16 billion. It is time to reassert and follow the principle that only one dollar is to be spent for each dollar earned, rather than burden future generations with our fiscal follies.

Tax Equity and Simplicity

We should seriously question whether there ever can be a truly equitable system of taxation. It is unlikely that historical research will uncover a prototype tax system which we can adopt or adapt. We might also question whether there is any ultimate good to be obtained in working toward a theoretically equitable system if it will be so unwieldy and complicated that, except for the creative originators, and a handful of skillful practitioners, it will not be understood. Moreover, an equitable system might not receive the expected acclaim if work incentives are stultified, if capital investment is discouraged, if persons on a poverty level are required to bear a minimum burden of taxation in exchange for the privilege of voting and enjoying the basic benefits of national government, etc. Such a system may, in fact, cause substantial economic disruption and political unrest.

A more basic question is whose sense of equity is to provide the guideline for taxation. The divergence of opinion amongst just and equitable men as to what is equitable may never be resolved. Resolution is further complicated by dynamic changes in economic conditions.

We acknowledge that our present tax system is not equitable. An extra exemption is afforded a blind person, but not a deaf person, quadruple amputee or other equally handicapped person. This is an accepted part of our tax code, but lacks reason and equity. No one would suggest removing this additional exemption, yet the revenue strain and administrative difficulty of extending an additional exemption to all handicapped persons prevents such "reform".

Stockholders are still subjected to double taxation on their investment return, once as corporate income and again as dividend income. Hardly equitable, but a part of our tax law.

We begin, therefore, with an inequitable system of taxation which is overly complex, difficult to follow and difficult to enforce. Clearly, there

are many improvements which can be made to further the sense of fairness and further simplicity in administration.

But fairness and simplicity are equally important objectives that complement each other. Nothing is to be gained by sacrificing one to the other. The complexities of our tax system are, in part, the progeny of inequity. Simplification and reform are possible when we deal with the cause rather than the symptom of inequity. H. R. 13270 fails to do this. Its complexities challenge the intellect of the expert tax practitioner. There are too few such experts available to help implement these provisions. Tax paying and tax practice will become more of a challenge than it is now. Ignorance and inadvertence will play an increased part in tax avoidance and further undermine public confidence.

We believe that every individual who has substantial income also has a responsibility to pay a fair share of tax. In an attempt to reach this objective, the present bill wreaks havoc with established tax concepts, basic individual freedoms, the formation of capital and the future growth of this nation's economy. If the present bill is enacted, we will face a situation in which the proverbial forest will be destroyed in an effort to cut down the unpruned growth of 155 trees.

The positions contained in this paper further the objectives of simplification and greater equity in our tax law. They affirm the tenets of capitalism and are directed toward the continued orderly development of our national economy.

APPROVE §121 - Tax on Unrelated Business Income

The "Clay-Brown" type of transaction is an abuse of the intent of existing code provisions. Allowing such deals contributes nothing to the national interest while it reduces tax revenue. It is this type of tax avoidance which undermines taxpayer confidence. We approve of the provision requiring an exempt organization to treat as unrelated business income that portion of income which the indebtedness on acquired property bears to the total value of the property.

Many tax exempt organizations receive income from business activities unrelated to their exempt purpose. Churches, civic leagues, etc. are now permitted to enjoy such business income without paying normal corporate income tax. This constitutes a distortion of the exemption concept and results in improper government financing of the activities of the exempt organization.

Permitting unrelated business income of exempt organizations to escape tax places comparable private business endeavors at a disadvantage. Moreover, new private business undertakings are discouraged since they cannot expect to compete successfully with an established business that operates free of income tax. The revenue gain from enactment of this provision may be higher than estimated, since creating a truly competitive situation will increase business activity. It is equally appropriate to restrict an exempt organization from engaging in business through a controlled subsidiary corporation.

Recreation and family entertainment is an expanded part of our national living pattern. Clearly a personal expense, it should be paid for with after-tax dollars. To the extent that certain social clubs have been able to shelter passive investment income, they are able to provide facilities with pre-tax dollars. This is inequitable and we approve of the corrective provision which would tax such income.

We approve of the new definition of "trade or business" which treats as unrelated business income advertising revenue in excess of publication

costs received by an exempt organisation. The competition for advertising dollars is intense. Recently a number of national magazines have discontinued publication as a result of inadequate advertising revenue. Neither the advertiser seeking exposure, nor the subscriber reading an ad, considers the tax status of the publisher as a factor in the ad's effectiveness. Hence, there is no basis for giving favored tax treatment to the exempt publication.

APPROVE §231 - Moving Expense

A high level of national employment is made possible by a mobile labor force. Mobility is also essential for the internal growth of nationwide business. Although Congress has recognized this in principle, the existing restrictive moving expense deduction is unrealistic and must be brought up to date.

Facilitating an employee's effort to advance his family's standard of living is in the national interest. In those cases where the move permits a dependent family to become a wage earning family, the cost of providing government assistance is avoided. A family move motivated by higher income results in an increased tax contribution.

In business today single site operations are as much a thing of the past as "mom and pop" grocery stores. Corporate employees must endure a number of moves as part of their development. In these situations, where the move is required by an employer, the employee does not necessarily receive a salary increment. Even when his salary is increased his unreimbursed moving costs often will result in a net financial loss that cannot be deducted from taxable income. Full reimbursement results in some taxable income and the after-tax situation will still be a net loss.

These problems are recognized and partially treated in §231. However, to the extent that the dollar limitations imposed are not commensurate with actual costs in today's market, the bill falls short of providing the necessary relief.

A family of four occupying temporary quarters in a metropolitan area can easily expect to spend more than $1,000 in a thirty-day period. Searching for a new home can take a few days. Hotel costs plus air fare can easily add another $600 disbursement. There should be no dollar limitation on this provision.

Although delayed occupancy of a new residence is considered, no provision is made for deducting the temporary storage charges which will have to be paid during this same period. Temporary storage charges should be included as a (b)(1)(A) expense which is not subject to limitation.

The section provides for inclusion in gross income as "compensation for services" any reimbursed moving expense. Thus, the employer will have withheld those taxes normally taken on wages paid. This will result in an out-of-pocket cash loss to the employee that will not be replaced until he receives a refund on filing his annual return. Another problem is presented in a situation where the employee does not use itemized deductions. In this case, the deduction would actually be lost while the amount of reimbursement would remain in income. We recommend that reimbursed moving expenses, to the extent that they are deductible, should not be treated as "compensation for services" and should be omitted from gross income.

DISAPPROVE §301 - Limit on Tax Preferences
DISAPPROVE §302 - Allocation of Deductions

We disapprove of both of these provisions as arbitrary, extremely complex and contrary to established principles of tax law.

The bill classifies certain income as tax preference income, namely, tax-exempt interest on state and local bonds; the deduction allowed individuals of one-half of net long-term capital gains, charitable contributions of property which has appreciated in value, the allowance of accelerated depreciation on real estate and the treatment of farm loss. Section 301 introduces the new and entirely novel concept of placing an overall limitation on these so-called tax preferences for individuals. This overall limitation is imposed even though the

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propriety and extent of safeguards with respect to each "preference" item has been separately dealt with in other parts of the bill.

The objective of §§301 and 302 is to impose a higher tax on a comparatively small group of wealthy taxpayers who make extensive use of existing tax provisions and thereby pay a relatively small amount of tax. The "preference" items are still considered sound and, as safeguarded by present and proposed law, will be available in full to the average taxpayer. Hence, the socially and economically desirable effects of these provisions are retained while the politically expedient step is taken of imposing a greater tax on wealthy persons.

Creating new taxpayer classifications is contrary to the concept of equal treatment before the law. If an item is deductible, such deduction is new available to all taxpayers. Allowing deductions and permitting tax incentives to some taxpayers and not others, proposes a method of tax discrimination which has no place in our system. As precedent for future legislation, treating taxpayers differently although the taxable event is the same, marks the accelerated decline of taxpayer confidence and promises further complexity in our tax law.

Section 302 has a similar limitation provision applying to deductions and is equally novel in our federal tax system. This provision segregates nonbusiness deductions and requires them to be allocated between taxable and tax preference income. The amount allocated to preference income is disallowed under a complicated formula. The theory apparently is that one having both taxable income and tax preference income could have paid these expenses proportionately out of both sources. Hence, it is arbitrarily presumed that he has done so regardless of any connection between income and expenses. We find such presumption to be unreasonable.

An example of tax distortion resulting from the application of this provision would be present in a situation where a taxpayer, having some preference income, realizes a substantial capital gain, i.e., on the sale of his wholly-owned

business. Here the infusion of a large amount of "preference" income will result in the disallowance of otherwise deductible expenses even though the proceeds from such long-term gain were not available to pay these expenses. This formula attempt at "reform" will actually produce new inequities which will certainly require further "reform".

The most serious and significant criticism of §302 is that it will affect the treatment of deductions that arise out of transactions completed well in advance of any proposal now embodied in the current legislation. The orderly planning and predictability of business and investment, which has always been a part of our tax laws, is unceremoniously discarded.

Both provisions create the problem of unintended tax consequences arising through the application of the formulae. Neither formula serves a sufficiently useful purpose to justify such result. The bill deals specifically with each of the "tax preference" items. We submit that the tax treatment of preference items and deductions should be made head-on. The direct handling of tax events permits taxpayers to evaluate the consequences of their transactions.

There should be no overall limitation on any kind of income nor should there be an overall arbitrary allocation of deductions. The complexity of the proposed formulae makes an exhaustive analysis of their effect impossible. This alone should be sufficient reason not to enact them.

APPROVE §311 - Income Averaging

We approve this proposed amendment as a step toward equality amongst taxpayers and as a striking demonstration of how tax simplicity is attainable when the primary problems are faced.

Eliminating the distortion of tax liability resulting from the timing of income was the primary objective of the existing section. Excluding capital gains and certain other income from the average was done in order to avoid manipulation and because of certain misconceptions. These exclusions, however, resulted in

complexity and limited use of the provision by taxpayers.

The House Committee Report stated, after discussing the amendments, "these changes will permit the elimination of 21 lines out of the 43 lines presently on the income averaging tax return form". This combination of reform and simplicity is an example of constructive tax legislation.

Liberalizing the averaging provision encourages taxpayers to take their income currently and avoids deferral schemes. It advances equity and furthers confidence in our tax system.

DISAPPROVE §331 - Deferred Compensation

The proposed change in the taxation of deferred compensation introduces two new formulae: The application of one formula requires extensive recordkeeping and places a burden on the taxpayer, matching deferred payments to income years, that can only encourage litigation. The alternative formula arbitrarily provides that if you aren't willing or able to comply with the recordkeeping requirement you must pay a higher tax since the deferred payment is related back to peak income years.

This involved procedure is intended to equate taxation of funded deferred payment arrangements with non-funded arrangements on the erroneous premise that the two are the same. The premise is incorrect since it assumes that a corporate promise of payment is equivalent to money set aside. The bankruptcy and reorganization of publicly-held corporations is not a unique occurrence. Moreover, financial misfortune in closely held companies often results in unfilled compensation promises.

A significant problem in applying the proposed section is the absence of a definition of "deferred compensation". Compensation agreements with executive personnel often include legitimate provisions for post-employment consulting. Many contracts are dependent on a post-employment, non-competition and nondisclosure of trade secrets provision. These clauses have real value to the

company and are usually assigned an equivalent dollar amount. To change the timing of income by relating these negotiated payments back to the year of active employment is tax distortion and not tax reform.

We disapprove of this provision as unnecessarily complex, too vague in application, and inappropriately based on an inaccurate premise.

DISAPPROVE §401 - Multiple Corporations

This subject is almost a perennial in the annals of tax reform. Congress has repeatedly weighed the pros and cons of allowing multiple exemptions to a "controlled group" of corporations and the present law reflects this exhaustive study. No new development in the past five years warrants any change in the treatment of multiple corporations. Adequate controls are contained in our law to prevent abuse of existing provisions.

The proposed amendment will effectively restrict the competitive ability of small business and discourage new business endeavors. For example, if Mr. A now successfully runs a single unit, take-out food store and forms a new corporation to operate at another location, he is placed at a competitive disadvantage in operating at the new location. His competitors will have less tax to pay on the same income and can maintain a fair return on investment using a lower selling price. The same result would obtain if Mr. A sought to enter an entirely unrelated field.

It is unquestioned that important business reasons exist for the operation of multiple corporations: limiting new venture capital to a set amount and protecting the capital of the original business from exposure to excess losses; limiting tort liability in the same way; permitting managerial incentive through stock participation in the operating unit; permitting labor and general business practice to conform easily to local standards. A corporation pursuing sound business and management objectives, via the multiple corporate route, would be paying a tax penalty under the proposed amendment. This is true for the smaller

as well as the larger controlled group.

The independent operation of retail outlets, whether part of a regional or national chain, have as much need for individual corporate status as business in a small controlled group. Each store requires competent management and appropriate incentives. The economic success of each store is determined by its local competitive position. Once again there should be tax equality between two competitors selling the same product in the same area. Changing the tax "cost", because of the legalism of ownership, upsets the free market balance and creates inequity rather than reform.

APPROVE §412 - Installment Method

The formula contained in existing law to avoid the arbitrary allocation of installment payments between return of principal and profit has proved to be equitable. We disapprove of the way in which the provision has been literally read and applied to situations that are not true installment sales.

We support the proposed amendment which restricts the installment provision to sales in which payments are actually made periodically. The treatment of a readily marketable debenture as a cash equivalent accords with generally accepted concepts, and should be approved.

DISAPPROVE §413 - Original Issue Discount on Bonds etc.

Objection is raised to this proposed change both on the theory advanced as well as the practical application of the amendment. There is no inherent virtue in parallel tax treatment between individuals and corporations. Attempting to assert parallelism as an objective that is preferable to maintaining the integrity of the cash and accrual accounting methods is to embark on a course of independent special tax rules that contravene existing accounting principles. The wisdom of further divergence of tax principles from accounting principles is questionable but totally unnecessary in the absence of a favorable revenue change. No revenue change is expected from this amendment.

The Report of the Ways and Means Committee observed that there is no basis for maintaining the current treatment of original issue discount. Overlooked is the fact that the earned discount on the retained bond is similar to the appreciation on a capital asset. Until the time of redemption or sale the taxpayer has nothing more in hand than an evidence of debt (ownership if it were stock) and no taxable event has occurred to fix the time or amount of income. What is the equitable tax treatment when the market value of the bond declines more than the amount of the "earned" discount? It can't be paying tax on the latter and having no deduction for the former, but that's what would happen under this amendment.

The extremely complex nature of the computations which will be required of bondholders, especially holders other than the original owner, will cause hardship and result in an unjustified recordkeeping expense. The burdensome administrative expense which enforcement would demand is avoided by shifting it to the issuing corporation. This situation provides no justification for saddling corporations with the costs of additional recordkeeping and preparing and mailing thousands of information returns.

DISAPPROVE §414 - Limitation on Deduction of Bond Premium Upon Repurchase

The proposed treatment of the premium paid upon repurchase of a convertible indebtedness does not sufficiently clarify the current situation. It limits deductibility to a "normal call premium" on non-convertible bonds except when the corporation demonstrates that a larger premium was paid as a cost of borrowing. This allegedly provides the flexibility necessary to take into account market and credit conditions. In effect it provides that unless the corporation and the Service agree upon the deduction, they can litigate the issue, and this hardly qualifies as tax reform.

This provision continues the practice of setting a value on the conversion feature of a convertible debenture which is issued for a price above par

while denying any value to such feature on a bond issued at par or at a discount. Since such treatment is not consistent it should not be extended.

APPROVE §421 - Stock Dividends

This proposed amendment to the existing provisions of law dealing with stock dividends is necessary to carry out the section's intended purpose. It frustrates the tendency to resort to complex financing and tax maneuvers in an effort to avoid the existing statutory provision. We approve of this amendment and the principle that receiving a proportionately increased stock interest in lieu of cash is taxable as equivalent to a cash distribution.

DISAPPROVE §461 - Increase Alternative Capital Gains Rate for Corporations

This provision simply raises corporate income taxes and has no relationship to anything akin to "reform". As a higher tax levy it is unwarranted and constitutes an ill-conceived method to assist in balancing the politically expedient individual rate reductions.

The reasoning advanced for this provision is specious. It is said that having proposed an increase in individual capital gains, corporations should be taxed similarly. It would be equally valid to suggest that corporations be allowed to include one-half their capital gain in income subject to tax at a 48% rate. There are many places in the Code where individuals and corporations are treated differently and trying to find parity in rates alone is neither equitable nor economically realistic.

It is also suggested that capital gains for a corporation is essentially the same as ordinary business income. This just is not true. The sale by a manufacturing company of a minority stock interest in another corporation is the sale of a capital asset and bears no relationship to the ordinary income derived from manufacturing.

DISAPPROVE §515 - Total Distribution From Qualified Pension etc. Plans

The existing treatment of lump-sum distributions from qualified plans encourages an employee to take his capital on retirement and put it into a business or other investment situation. This stimulates the economy and encourages continued individual productivity.

The proposed change imposes an unnecessary hardship on retirement if an election is made to take a lump-sum payment. A more severe result is obtained when the lump-sum payment is made as a result of involuntary termination of service during normal income years. In the latter situation the extra tax burden is faced from the unenviable position of unemployment. In a case where the termination occurs after an employee receives nearly a full year's ordinary income, the amount of tax due would be substantial.

Furthermore, this section will apply to plans covering more than five million employees most of whom are not high income individuals. The tax return preparation tasks of these people will be made horrendously complicated. Moreover, many of them who have kept their savings and employer contributions in such plans to obtain capital gain treatment may, where possible, withdraw from the plans. This would be an unfortunate, and certainly an unintended, consequence of this section.

We believe the present provision works well and carries out long-range economic objectives. It should be retained. Amending the existing provision will result in strained planning techniques which, in turn, will evoke demand for tax reform.

DISAPPROVE §521 - Depreciation of Real Estate

Any alleged abuse in the use of accelerated depreciation should be corrected, but the proposed amendment does not constitute reasonable remedial legislation. It eviserates the construction industry and in the process creates unintended hardship for all business.

The currently allowable depreciation rates have been a strong stimulus for new construction. To the extent that it remains available for residential housing it will continue to spur new building. The proposed restrictions, in the light of current mortgage conditions, would further curtail modernisation of manufacturing facilities. The lack of ready mortgage money has already forced business to either postpone new plant construction or provide a greater portion of the required capital. This setback in modernization comes at a time when rising labor costs are squeezing profit margins and pressing price levels. Only through modernization has industry managed to compensate for higher unit costs and hold down price increases. We see no justification for discouraging modernization, which will occur if business cannot take accelerated depreciation and retrieve badly needed investment capital.

The proposal will also increase the cost of commercial rental space and, in turn, add to the cost of doing business. The net short-term result of this provision is inflationary and contrary to current objectives. We urge that the status quo be maintained at this time.

APPROVE §§801-804 - Tax Relief Provisions

These four sections of the bill afford tax relief in a variety of ways but the relief proposed is actually a tax reduction. As previously stated, we support the proposed reductions but do not believe that our present inflationary economy or our budgetary problems permit such reductions at this time. If any priority is to be given to some of these proposals our attention would focus on the low-income allowance formula and the maximum rate on earned income. The former would bring taxable income above the poverty level and set a realistic minimum level for levying an income tax. The latter corrects the confiscatory nature of our present graduated system and thus relieves the constant pressure for tax gimmickry. Both go a long way toward achieving greater equity in our tax law.

We urge the enactment of these provisions as soon as such legislation can be reconciled with our fiscal policy and a balanced budget.

DISAPPROVE OF ALL PROVISIONS
HAVING RETROACTIVE APPLICATION

A number of proposed provisions will apply to investments made and transactions concluded prior to the time that H. R. 13270 was introduced. The tax effects considered at the time these transactions were undertaken were reasonably based on the then existing law. Taxpayers have a right to enter into long-range business and investment plans that offer a calculated return. Predictability of action based on existing law is one of the basic principles sustaining the integrity of our system of laws. It is unfair to change the results of irrevocable contracts etc. by changing the treatment of existing income or deductions. Although this is generally recognized, not all provisions of the present bill limit their impact to prospective events.

We urge that equity requires all amendments of existing law to be limited in their application to taxable events and conditions which occur after the date of enactment.

CONCLUSION

No inference is to be drawn from the fact that certain provisions of H.R. 13270 have not been discussed in the foregoing remarks. The extensive nature of the proposed changes exceeded our ability to do a complete analysis of the entire bill. Our efforts were limited to those provisions having the greatest effect on the majority of our diversified membership.

We trust that this Committee will report a tax reform bill that will benefit the national economy and neither attempt to provide short-lived advantages for individual taxpayers nor penalize the business and investment community. The prosperity of our nation cannot be fragmented. We expect legislation that will preserve a free enterprise system and foster the economic and social development of this nation for the good of all our citizens.

SUMMARY STATEMENT OF THE AMERICAN HOTEL & MOTEL ASSOCIATION

BEFORE THE SENATE FINANCE COMMITTEE, U. S. SENATE

ON H. R. 13270

PROPOSED INCREASE IN CORPORATE ALTERNATE CAPITAL GAINS RATES FROM THE PRESENT 25% TO 30%

The American Hotel & Motel Association contends that the proposed change under Section 461 of H.R. 13270 should be deleted because it is grossly unfair. Corporations having taxable income are taxed thereon and the same income is taxed again to its stockholders as dividends at normal tax rates. It can therefore be seen that the beneficial owners of a corporation, i.e., the stockholders, are taxed twice on the same income. Where a corporation realizes a capital gain, and pays tax thereon at corporate gains rates, such gain when distributed to stockholders as an ordinary dividend is taxed again at normal tax rates.

RETENTION OF ALTERNATIVE METHODS OF DEPRECIATION PROVIDED IN SECTION 167 OF THE INTERNAL REVENUE CODE

Section 521 of H.R. 13270 proposes changes in the use of the accelerated methods of depreciation. These proposed changes are objectionable for the reason that they are unrealistic.

While Section 521 of the proposed bill allows use of the 150 percent declining balance method on new construction of hotel and motel properties, older properties purchased do not share such treatment, yet the depreciable factors remain the same. There is a difference, however, between the depreciation on newly constructed properties as compared with used properties purchased. It is a fact that more depreciation occurs in the case of newly constructed

properties than in used properties during the early years of their useful lives. This fact has been recognized by the provisions of Section 167 of the Code which permits the 200 percent declining balance and the sum-of-the-year digits methods, in the case of newly constructed properties and a maximum of 150 percent declining balance method for used properties, and these provisions should be maintained.

RETENTION OF PRESENT RULES REGARDING RECAPTURED DEPRECIATION AS PROVIDED IN SECTION 1250 OF THE INTERNAL REVENUE CODE

Another part of Section 521 of H.R. 13270 provides for a tax at ordinary rates on any gain realized on the disposition of depreciable real property to the extent of the excess of depreciation claimed on any accelerated method over the amount of depreciation which would be allowed computed on a straight-line method with respect to deprecia-tion applicable to taxable years ending after July 24, 1969.

No matter how long a depreciable asset has been used in trade or business, no consideration is given to the part which inflation plays in fixing the selling price of an asset. As a consequence, in-come tax is imposed on the increase in value due to inflation, with the result that the asset disposed of cannot be replaced with an asset of equal value without borrowing funds to replace the income tax paid.

The current law gives some effect to the inflationary aspect of the economy. It is respectfully submitted that to convert what would in whole or in part be presently taxed as capital gains into ordinary

income to individuals and taxed to them at their highest surtax bracket is drastic and excessively burdensome. Since the beneficial owners of corporations, i.e., the stockholders, in effect pay double taxes, to convert the corporate gain from capital gain status to ordinary income tax classification is equally offensive.

EFFECT ON EARNINGS AND PROFITS OF DEPRECIATION

The Association is opposed to Section 452 of H.R. 13270 dealing with the effect on earnings and profits of accelerated depreciation on the basis that it introduced a double standard (1) for the determination of taxable net income, and (2) for the computation of earnings and profits.

It is submitted that when depreciation is computed in accordance with the provisions of the law, such depreciation equates that which is proper, reasonable and just; otherwise, such depreciation method should not be allowed in the first instance. If depreciation is considered correct, and recognized in the determination of net income to be taxed, then such depreciation should be accepted in computing earnings and profits.

ELIMINATION OF MULTIPLE SURTAX CORPORATE TAX EXEMPTIONS AND OTHER BENEFITS

The Association objects to the provisions of Section 401 of H.R. 13270 which would eliminate the multiple corporate surtax exemption and other related benefits and such objection is on the broad basis of inequality.

Section 401 of the bill discriminates among taxpayers. This observation is predicated on the fact that two or more separate business activities owned by different interests will pay less income

tax than if the same business were owned by common control. It is clear, therefore, that a penalty is being imposed on a multiplicity of business activities which can only be labeled as repressive and discriminatory. There should be no tax penalty imposed upon the business community in conducting business activities in a multiplicity of corporate forms that are found essential and desirable in the ordinary course of business. All members of the community should be given an equal opportunity to conduct their business activities in a corporate setup found to be desirable and competitive without being penalized for doing so by our tax laws.

UNRELATED BUSINESS TAX SECTIONS
511 AND 513 OF THE I.R.C.

We are in general agreement with the provisions contained in Section 121 of H.R. 13270 which would extend the "unrelated business income tax" to virtually all exempt organizations and would also impose a tax on the investment income of such organizations. We request, however, that the bill be amended so as to exclude from "unrelated trade or business" the activities of a trade show sponsored by a business league coming under Section 501 (c) (6).

The final I.R.S. regulations regarding certain activities of 501(c)(6) organizations, as issued on December 12, 1967, and Section 278 (c) of the bill would seem to imply that a trade show of a type common to the hotel/motel industry represented an "unrelated trade or business," as defined in Section 513, and that the gross income derived therefrom was taxable as "unrelated business income" as provided for in Section 511.

In Rev. Rul. 67-219 and the regulations, the I.R.S. takes the position that income from trade shows is not unrelated income where

the exhibits are for products or services utilized by the sponsoring organization's members. We respectfully wish to point out that if the I.R.S. approves of trade shows at which individual members of a tax-exempt business league display their products to their potential customers, then surely the display at an industry trade show by suppliers of products used in the industry is within the activities and purposes of the industry's business league.

It is, therefore, requested that Section 513(a) of the I.R.C. be amended to exclude from the category of unrelated trade or business" the conduct of a trade show sponsored by a business league exempt from tax under 501(c)(6).

33-758 O - 69 -- No. 16 -- 6

October 2, 1969

STATEMENT OF THE

AMERICAN HOTEL & MOTEL ASSOCIATION

BEFORE THE

SENATE FINANCE COMMITTEE

U. S. SENATE

ON H. R. 13270

I am Arthur J. Packard, President of the Packard Hotel Company and Chairman of the Governmental Affairs Committee of the American Hotel & Motel Association.

The Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico, and the Virgin Islands having a membership in excess of 6,800 hotels and motels containing in excess of 750,000 rentable rooms. The American Hotel & Motel Association maintains offices at 221 West 57th Street, New York, New York, and at 777 - 14th Street, N. W., Washington, D. C.

I am accompanied by Mr. Paul V. Wolfe of the national hotel and motel accounting firm of Harris, Kerr, Forster & Company, who will testify on behalf of the Association on tax areas important to the hotel/motel industry which are a part of these tax reform hearings.

* * * * * * * * * * * * * *

My name is Paul V. Wolfe, a partner in the national accounting firm of Harris, Kerr, Forster & Company, which is headquartered at 420 Lexington Avenue in New York City.

I am appearing today on behalf of the American Hotel & Motel Association to testify on portions of H.R. 13270 which are of primary interest to the Association.

GENERAL COMMENTS REGARDING HOTELS AND MOTELS

In considering the comments I am going to make regarding the taxation of capital gains and accelerated depreciation, I feel it is important to have in mind that hotels and motels are required to invest very substantial sums in land, structures and equipment and they actually operate a business. They are not passive investors. In addition, they employ vast numbers of unskilled and semi-skilled help consisting of maids, bellboys, waiters, maintenance personnel and similar service employees. Hotels and motels, besides being a very important segment of our social and business community, play a very important role as host to foreign travelers in our country. This role of host to foreign travelers will be stepped up very substantially in the near future by reason of the fact that there is on the horizon mass inter-continental transportation due to the construction of larger jet planes. In view of this observation it can be expected that hotels and motels should be encouraged to fulfill their destined role as a contributor to the improvement of our balance of payments program.

PROPOSED INCREASE IN CORPORATE ALTERNATE CAPITAL GAINS RATES FROM THE PRESENT 25% TO 30%

The American Hotel & Motel Association contends that the proposed change under Section 461 of H.R. 13270 is grossly unfair to corporations. It must be borne in mind that corporations having taxable income are taxed thereon and that the same income is taxed again to its stockholders as dividends at normal tax rates. It can

therefore be seen that the beneficial owners of a corporation, i.e., the stockholders, are taxed twice on the same income. Where a corporation realizes a capital gain, and pays tax thereon at corporate gains rates, such gain when distributed to stockholders as an ordinary dividend is taxed again at normal tax rates.

One of the reasons given for the increase in the alternate capital gains rates from 25 percent to 30 percent is the alternate capital gains tax for individuals is being eliminated. It is submitted that the alternate capital gains rate on individuals and corporations are not apposite since as pointed out above corporate capital gains are taxed twice whereas individual capital gains are taxed once.

By reason of the foregoing analysis, it is felt that the changes in the corporate alternate capital gains tax proposed in Section 461 should be eliminated, and that the present tax provisions of our Code dealing with alternate corporate capital gains rates should be retained.

RETENTION OF ALTERNATIVE METHODS OF DEPRECIATION PROVIDED IN SECTION 167 OF THE INTERNAL REVENUE CODE

Section 521 of H.R. 13270 proposes changes in the use of the accelerated methods of depreciation. These proposed changes are considered by the American Hotel & Motel Association to be objectionable for the reason that they are unrealistic and unfair. With respect to proposed changes in the use of the 200 percent declining balance and sum-of-the-years digits method contained in Section 167 of the I.R.C., it is desired to highlight the observation that these methods are economically sound and factually realistic.

The purpose of depreciation is to allow a taxpayer to recoup its tax basis over its economic useful life. It is a fact that an asset depreciates more in the earlier years of its useful life and less in later years. Repairs are less in the earlier years of the life of an asset and increase at an accelerated rate as the asset gets older. Accelerated depreciation, therefore, gives effect to physical realities and results in equalizing charges against income over the useful life of a depreciable asset. This result is accomplished by a larger write-off for depreciation with small repair incidents in earlier years and larger repairs and smaller depreciation as useful life progresses.

While Section 521 of the proposed bill allows use of the 150 percent declining balance method on new construction of hotel and motel properties, older properties purchased do not share such treatment, yet the depreciable factors remain the same. There is a difference, however, between the depreciation on newly constructed properties as compared with used properties purchased. It is a fact that more depreciation occurs in the case of newly constructed properties than in used properties during the early years of their useful lives. This fact has been recognized by the provisions of Section 167 of the Code which permits the use of the 200 percent declining balance and the sum-of-the-years digits method in the case of newly constructed properties and a maximum of 150 percent declining balance method for used properties.

Factually, it would be unjust and improper to cut down the present permissible rates on newly constructed hotel and motel properties from the 200 percent declining balance method or the sum-of-

the-years digits method to the 150 percent declining balance method and to also cut down the present rate of depreciation on used properties from the 150 percent declining balance method to the straight-line method. The changes proposed in the permissible use of accelerated methods of depreciation would be completely at variance with the true loss of economic value in the form of depreciation in computing taxable net income.

The retention of the present allowable 200 percent declining balance and the sum-of-the-years digits method enables business organizations to repay their loans quicker, thereby reducing interest expense. In addition, the presently allowed accelerated methods help hotel and motel industries to cope to some extent with inflationary costs. This is accompanied by an earlier larger cash throw-off being payable through the use of such methods.

In view of the foregoing, it is requested that Section 167 of the Internal Revenue Code be left unrevised.

RETENTION OF PRESENT RULES REGARDING RECAPTURED DEPRECIATION AS PROVIDED IN SECTION 1250 OF THE INTERNAL REVENUE CODE

Another part of Section 521 of H.R. 13270 provides for a tax at ordinary rates on any gain realized on the disposition of depreciable real property to the extent of the excess of depreciation claimed on any accelerated method over the amount of depreciation which would be allowed computed on a straight-line method with respect to depreciation applicable to taxable years after July 24, 1969.

The American Hotel & Motel Association is firm in its opinion, under our present inflated economy, that any gain realized on the

disposition of hotel and motel properties should not be taxed at all, but feels that if a tax must be imposed, the tax provision of the present law should be retained and applied.

On the sale or taxable exchange of depreciable assets, gain or loss is computed on the difference between adjusted tax cost and the sales price. Adjusted tax cost is original cost less depreciation allowed or allowable. No matter how long a depreciable asset has been used in trade or business, no consideration is given to the part which inflation plays in fixing the selling price of an asset. As a consequence, income tax is imposed on the increase in value due to inflation, with the result that the asset disposed of cannot be replaced with an asset of equal value without borrowing funds to replace the income tax paid.

The current law gives effect to the inflationary aspect commented upon by giving some relief at capital gains rates on the gain realized on the sale of depreciable real estate held over 20 months on declining rates with full capital gains tax on profits derived from the sale of such assets held more than 10 years.

It is respectfully submitted that to convert what would in whole or in part be presently taxed at capital gains rates into ordinary income to individuals and taxed to them at their highest surtax bracket is drastic and excessively burdensome. Since the beneficial owners of corporations, i.e., the stockholders, in effect pay double taxes, to convert the corporate gain from capital gain status to ordinary income tax classification is equally offensive.

In view of the foregoing, it is recommended that the present provisions of Section 1250 of the I.R.C. be retained as presently constituted.

EFFECT ON EARNINGS AND PROFITS OF DEPRECIATION

The Association is opposed to Section 452 of H.R. 13270 dealing with the effect on earnings and profits of accelerated depreciation on the basis that it introduces a double standard (1) for the determination of taxable net income, and (2) for the computation of earnings and profits.

It is submitted that when depreciation is computed in accordance with the provisions of the law, such depreciation equates that which is proper, reasonable and just; otherwise, such depreciation method should not be allowed in the first instance. If depreciation is considered correct, and recognized in the determination of net income to be taxed, then such depreciation should be accepted in computing earnings and profits. For the reasons stated, it is urged that Section 452 of the proposed bill be deleted.

ELIMINATION OF MULTIPLE CORPORATE SURTAX EXEMPTIONS AND OTHER BENEFITS

The Association desires to express its objection to the provisions of Section 401 of H.R. 13270 which would eliminate the multiple corporate surtax exemption and other related benefits and such objection is on the broad basis of inequality.

Presently, in order to obtain a multiple surtax exemption, an election must be made by each member of a controlled group of corporations. As a consequence of this election, each corporation in the controlled group is required to pay an added 6 percent tax on the first $25,000 of their taxable net income pursuant to Section 1562 of the Internal Revenue Code. This privilege carries with it other concomitant benefits which are proposed to be eliminated together with the multiple surtax exemption under the proposed bill.

It is submitted that Section 401 of the bill discriminates among taxpayers. This observation is predicated on the fact that two or more separate business activities owned by different interests will pay less income tax than if the same business were owned by common control. It is clear, therefore, that a penalty is being imposed on a multiplicity of business activities which can only be labeled as repressive and discriminatory. There should be no tax penalty imposed upon the business community in conducting business activities in a multiplicity of corporate forms that are found essential and desirable in the ordinary course of business. All members of the community should be given an equal opportunity to conduct their business activities in a corporate setup found to be desirable and competitive without being penalized for doing so by our tax laws. The provisions of Section 401 would have that effect. All members of the business community should be given an opportunity to expand and diversify their business activities without being hampered by penalty taxation.

UNRELATED BUSINESS TAX SECTIONS 511 AND 513 OF THE I.R.C.

We are in general agreement with the provisions contained in Section 121 of H.R. 13270 which would extend the "unrelated business income tax" to virtually all exempt organizations and would also impose a tax on the investment income of such organizations. We request, however, that the bill be amended so as to exclude from "unrelated trade or business" the activities of a trade show sponsored by a Section 501(c)(6) organizations.

(a) Section 511 of the I.R.C. should be extended to cover Section 501(c)(4), 501(c)(7), and 501(c)(8) organizations.

The Association has been constantly alerted by its members to the "business" activities of various organizations which have been granted tax-exempt status. This is especially true of organizations which come under Sections 501(a) and 501(c) of the Code. Evidence of such activity is most often in the form of either public invitations from the organizations or published information of the activities after they have occurred.

It has been our regular practice to forward evidence of such "business" activity to the I.R.S. To date we have seen little curtailment of the activities which form the basis of our objections. If anything, the volume of "business" by such organizations appear to be on the increase.

Most often this activity--which we prefer to term "unfair competition"--consists of solicitations on behalf of tax-exempt organizations for the business of the general public. Organizations which have been granted a tax exemption under Sections 501(c)(4), (7) and (8) openly seek and obtain business which would otherwise be available to tax-paying hotels and motels. More specifically, civic organizations, social and recreation clubs, and fraternal beneficiary societies "open their doors to the public" in the solicitations of lodging and food service business.

Under the provisions of the Code and the regulations thereto, Section 501(c)(4), civic organizations, must be neither organized nor operated for profit; Section 501(c)(7), social and recreation clubs, must be organized and operated exclusively for pleasure, recreation and other non-profitable purposes and must not make their facilities available to the public; and Section 501(c)(8), fraternal beneficiary

societies, must be operated in furtherance of their fraternal purposes and may not engage in business activities of a kind carried on with nonmembers for a profit.

In 1964 the I.R.S. issued Revenue Procedure 64-36 regarding certain activities of Section 501(c)(7), social and recreation clubs. In these so-called "guidelines" the Service stated that advertising or other solicitations for business by such organizations would be prima facie evidence that such a club is engaging in business and is not being operated exclusively "for pleasure, recreation and other non-profitable purposes." This portion of the guidelines merely reiterated past I.R.S. regulations.

The guidelines further stated that a 501(c)(7) organizations would be allowed annual gross receipts from business activities of $2500 or less without jeopardizing its exemption. Where such receipts exceeded $2500, they must have been 5 percent or more of the organization's total receipts before tax-exempt status would be jeopardized. The guideline further noted that member sponsorship arrangements would not circumvent the gross receipt limitation. If the organization's members constituted less than 75 percent of the total number of persons utilizing the organization's facilities on a particular occasion, all of the receipts received therefrom would be considered nonmember receipts unless the organization can properly apportion such receipts between members and nonmembers.

Revenue Procedure 64-36 appears on the surface to be a recognition by the I.R.S. that 501(c)(7) organizations do, in fact, often extend their activities to those who are outside their membership and their guests. We submit that Revenue Procedure 64-36 has not

deterred such activities which are in addition to a club's purpose and are, therefore, unrelated and should be taxed as such.

In view of the similarity in both the manner in which tax-exempt status is granted to 501(c)(4) and 501(c)(8) organizations and the methods employed by such organizations in soliciting business from the general public, we request that the provisions of Section 511 of the Code be likewise extended to these organizations.

By complying with the request to have 501(c)(4), 501(c)(7) and 501(c)(8) organizations covered by Section 511 of the Code, such organizations will be contributing a proper share to the revenue from the profits realized on activities that are foreign to purposes for which they were formed.

(b) Section 513(a) of the I.R.C. should be amended to exclude from Unrelated Trade or Business the Activities of a Trade Show Sponsored by Section 501(c)(6) Organizations.

The final I.R.S. regulations regarding certain activities of 501(c)(6) organizations, as issued on December 12, 1967, implied that a trade show of a type common to the hotel/motel industry represented an "unrelated trade or business," as defined in Section 513, and that the gross income derived therefrom was taxable as "unrelated business income" as provided for in Section 511.

Numerous regional, state or city hotel and motel associations sponsor a trade show no more than once a year. Space is assigned to various exhibitors desirous of participating, for which they pay a consideration. There are numerous exhibitors at the show whose products are normally used in hotel and motel operations. Some exhibitors may sell their products or services at trade shows whereas

others merely display or advertise their wares. No hotels or motels participate in these trade shows as exhibitors.

Normally, these trade shows are held at the time of the year when there is an annual meeting of the membership, i.e., when the members gather to discuss the affairs of the association, lay out future programs of the association, have guest lecturers on subjects of hotel/motel interest and business promotion, and elect officers. In short, at the annual meetings, there are many programs presented representing a common interest to the members of the association. In view of the fact that the members meet annually, it is felt a most appropriate time to infuse into such meetings a program of education for the membership, as well as to call to their attention the developments in various fields relating to the products which they use in the conduct of their hotel or motel business; hence, the trade show.

It can, therefore, be seen that these trade shows are an essential and integral part of the purpose for which the state and city associations have been formed. Through the trade shows the overall economy of a multitude of different types of businesses are represented and in this regard there is no isolated interest in one particular industry, but a wide divergency of industry activity and services. Through the means of such trade shows the membership of the various state or city hotel and motel associations are kept abreast of the improvements in various industries that are essential to their operations and an integral part of our national economy.

At such trade shows the public is generally not admitted, and it is only in an exceptional case, where there is some relationship to a hotel or motel activity, that a member of the general public may

be admitted. The membership of the hotel or motel association that sponsors the trade show normally pay a registration fee to attend the annual meeting and its auxiliary activities including the trade show.

It is submitted that the foregoing described activities fall directly within those permitted a trade association which is exempt from income tax per Section 501(c)(6). Such a trade show is clearly not the conduct of an "unrelated trade or business" within the meaning of Section 513. The receipts from such an activity should be clearly exempt from the tax on "unrelated business income" imposed by Section 511.

In Rev. Rul. 67-219 and the regulations, the I.R.S. takes the position that income from trade shows is not unrelated income where the exhibits are for products or services utilized by the sponsoring organization's members. We respectfully wish to point out that if the I.R.S. approves of trade shows at which individual members of a tax-exempt business league display their products to their potential customers, then surely the display at an industry trade show by suppliers of products used in the industry is within the activities and purposes of the industry's business league.

Trade shows sponsored by Section 501(c)(6) organizations for the purpose of enabling their members to keep up with current product and service development all toward making more efficient and profitable the member's business activities is one of the universal purposes of Section 501(c)(6) organizations. In view of this fact, all trade show activities so sponsored and conducted should be classified as related to the purposes and objectives of such organizations and any income realized from such trade shows so classified.

It is, therefore, requested that Section 513(a) of the I.P.C. be amended to exclude from the category of "unrelated trade or business" the conduct of a trade show sponsored by a business league exempt from tax under 501(c)(6).

STATEMENT OF CARL A. BECK
for the
NATIONAL SMALL BUSINESS ASSOCIATION
before the
SENATE FINANCE COMMITTEE
on the
TAX REFORM BILL (H.R. 13270)
October 2, 1969

Summary

1. The concept of a "normal" corporation income tax on profits of $25,000 goes back to the "Thirties." Since that time the dollar has lost almost 75% of its value. Today's technology requires proportionately larger investments by small business in plant and equipment. We believe tax equity demands that the "normal" corporate tax be applied to the first $100,000 of corporate taxable income because of (1) the depreciation of the value of money and (2) the added capital requirements of small business. The fiscal effect of increasing the level of surtax exemption from $25,000 to $100,000 is almost exactly equal to lowering the tax rate 2% on the first $1 million dollars of corporate profits.

2. Sec. 452 of H.R. 13270 restricting the use of accelerated depreciation by all corporations unduly penalizes the smaller firm. In the case of small business, investments are sporadic and any single purchase of equipment is a large percentage of the total capital invested in the business. In the case of large corporations the effect of Sec. 452 would be relatively minuscule compared with the smaller corporation. Rapid depreciation more nearly reflects the actual -- and true -- rate of depreciation of plant and machinery. Accelerated depreciation is vital to small business in that it allows the entrepreneur a return of capital to be reinvested thus permitting the smaller business to expand and keep modern.

3. Meaningful tax reform with respect to cooperatives is presented in S. 2646 (Ribicoff) as it places the co-ops on the same tax basis as other business enterprises, making them fully taxable on the profits which they earn. We support the provisions of S. 2646 with respect to cooperatives, and urge their substitution for Sec. 531 of H.R. 13270.

4. We support, in principle, the provisions of Sec. 121 of H.R. 13270 relating to the business income of now tax-exempt organizations. Income derived by such organizations from commercial transactions in direct competition with taxpaying business should not be tax exempt.

5. Our proposals strengthen fiscal soundness of our nation -- a basic objective of National Small Business Association -- by encouraging a sound long-range build-up of a vital productive sector of our economy.

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STATEMENT OF CARL A. BECK

for the

NATIONAL SMALL BUSINESS ASSOCIATION

before the

SENATE FINANCE COMMITTEE

on the

TAX REFORM BILL (H.R. 13270)

October 2, 1969

Mr. Chairman and Members of the Committee:

My name is Carl A. Beck. I appear as Chairman of the Board of Trustees of National Small Business Association. I am President of the Charles Beck Machine Corporation, King of Prussia, Pa.

1. We urge that the corporate surtax exemption be increased from $25,000 to $100,000.

2. We recommend that Section 452 be amended to permit the use of accelerated depreciation by small and medium-sized businesses.

3. We endorse the provisions of S. 2646 (Ribicoff) with respect to cooperatives, and urge their substitution for Sec. 531 of H.R. 13270.

4. We support, in principle, the provisions of H.R. 13270 relating to taxation of the business income of now tax-exempt organizations.

I. SMALL BUSINESS COMMUNITY IS BEING OVERLY PENALIZED IN PROPOSED TAX REVISION

A. Corporate Surtax Exemption Should Be Increased from $25,000 to $100,000

Secretary of the Treasury Kennedy in his statement of September 4, 1969 to the Committee pointed out that H.R. 13270 is "weighted in favor of consumption to the potential detriment of the nation's productive investment." To his statement we would add that the detriment to the nation's productive investment would be concentrated to a large degree in the small business sector. The cumulative effect of monetary and fiscal controls with associated high interest rates, loss of the 7% investment credit, the proposed 2% increase in corporate tax rates, and the current 10% surcharge on tax rates, will be to restrict substantially investments by small business in new plant and equipment.

The competitive position of small manufacturing, wholesale and retail establishments *vis-a-vis* their big business counterparts will be adversely affected. In order to remain competitive with big business in this period of rapidly advancing technology, small business needs to modernize plant and equipment to keep pace with the giants. Incentives to investment are there - but small business must find the capital for investment either through moneys withheld in the form of profits or by borrowing. I do not think it is necessary to tell the Committee that, for all practical purposes, the credit now available to small business is both too little and too expensive. Sources of funds for small business expansion, except for money generated by the business itself, have just about dried up. SBA funds except for disaster loans and loans to minority businesses are practically non-existent at the present time. Bank loans at under 10% are all

but impossible and for obvious reasons preference is given to the large borrower.

Equity financing by floating stock or bond issues in the current depressed market is not attractive because of the high premium which the small corporation must pay in brokerage fees, legal fees, high interest and low stock prices.

What is left? Reinvestment of the profits from the business.

We believe that as a matter of tax equity and long-range social and economic policy, this Committee must make an adjustment to the proposed Tax Reform Act to make it possible for small business to generate sufficient capital from income to be able to continue to make investments in new plant and equipment. "Free enterprise" in this time of economic readjustment must not be made to absorb disproportionately the government-imposed disincentives to economic growth, efficiency and modernization. We would prefer, obviously, that the 7% investment credit be retained up to say $50,000 per year, but since the Administration is determined that the investment credit be sacrificed, we most urgently recommend to the Committee that relief in the form of an adjustment to the corporate surtax structure be adopted.

The concept of giving small business preferential treatment by permitting it to retain a larger proportion of its income to be reinvested for growth is not new. The concept of a "normal" corporation income tax on profits of $25,000 or less with a surtax on corporate profits of over $25,000 goes back to the "Thirties". Since that time the dollar has lost almost 75% of its value. In addition today's technology requires proportionately larger investments by small business in plant and equipment.

Therefore, the depreciation of the value of money plus the added capital requirements of small business, argue that the surtax should not apply until

the $100,000 level is reached.

We believe that in the light of the current surcharge of 10% and the repeal of the investment credit, tax equity demands that the small corporation be given some additional tax advantages. We recommend that the "normal" corporate tax be applied to the first $100,000 of corporate taxable income in lieu of restructuring the corporate surtax currently in the law.

> The fiscal effect of increasing the level of surtax exemption from $25,000 to $100,000 is almost exactly equal to lowering the tax rate 2% on the first 1 million dollars of corporate profits. In the first case the government would lose approximately $19,500 in taxes (that is, $75,000 x 26% = $19,500); in the latter case the government would lose $20,000 (2% x $1 million = $20,000).

From the standpoint of the small business community, we believe it is in the national interest to have an additional $20,000 become available for investment to each corporation making less than $100,000 in profits rather than having it available to the corporation making $1 million. Corporations with incomes in excess of $1 million, from the standpoint of tax equity, should not be given under the Tax Reform Bill a tax position preferable to that which they currently enjoy. Disincentives to investment and expansion should fall most heavily on those corporations best able to absorb them. Incentives to investment and expansion should be given to those corporations most needful of them, and this would be accomplished by increasing the level of surtax exemption from $25,000 to $100,000.

B. Accelerated Depreciation Is Needed by Small Business to Keep Growing and to Keep Competitive

In addition to the possible loss of the investment tax credit and the continuation of the tax surcharge, additional hardships on the small business community would be created by enactment of H.R. 13270 in its present form.

The effect of Sec. 452 of the Tax Reform Bill restricting the use of accelerated depreciation by all corporations would be to severely penalize the logical and legitimate objectives of investor-owners of small business corporations to grow and keep modern through reinvestment of equity capital.

> In the case of small business, investments are sporadic and any single purchase of equipment is a large percentage of the total capital invested in the business. The "return of capital" in excess of earnings and profits in essence makes more of the small entrepreneur's capital investment available for reinvestment in his company. This provides a source of self-generated growth capital for small business, which otherwise must seek to obtain the capital from some other source, or do without it.

In the case of large corporations, there is constant long-range investment of new capital and the effect of Sec. 452 of the Bill would be relatively minuscule compared with the effect on the smaller corporation. The averaging of depreciation rates by the large corporation results in long-term depreciation which is not substantially different than straight-line depreciation. However, there will be the transitional effect of adjustment of accelerated depreciation to straight-line depreciation.

Rapid depreciation methods were adopted originally in the interest of the small business man to permit quick recoupment of capital for reinvestment, because accelerated depreciation methods more nearly reflect the actual -- that is, the true -- rate of depreciation of plant and machinery. To keep growing and to keep competitive, the small business rate of reinvestment should at least reflect, or exceed, the true rate of depreciation of plant and machinery.

Congress and Internal Revenue need to be reminded continuously that no one has ever suggested that more than 100% of the value of an investment should be depreciable. To the extent that rapid depreciation rates are offset against profits and income in early years the "piper" must be paid in later years, unless, in fact profits and income generated by substantially-depreciated assets decline in proportion to the depreciation taken. In the latter case no one can really complain. In the former case the government ultimately collects its pound of flesh in the shape of an increased taxable income base.

Now we have no great argument that large corporations, real estate investment trusts, and certain other business ventures may be able to convert some ordinary income into long-term capital gains by use of accelerated depreciation, and that such income may not as "return of capital" normally find its way into capital reinvestment. However, we feel that the tax equity in such situations is being achieved and is better achieved through recapture provisions (such as those now contained in IRC Sections 1245 and 1250) than by the shot-gun approach of the Tax Reform Bill. The shot-gun approach destroys the valid objectives of accelerated depreciation as a device to permit timely modernization and replacement of capital assets by growing businesses.

II. ORGANIZATIONS COMPETING WITH PRIVATE ENTERPRISE IN THE MARKET PLACE SHOULD BE SUBJECT TO THE SAME TAXES AS PRIVATE ENTERPRISE.

A. Enactment of Section 121 of H.R. 13270 Would Help Stop Discrimination Against Tax-Paying Business.

The earnings of tax-sheltered businesses are indistinguishable in principle from the earnings of an ordinary tax-paying corporation. The earnings are derived from precisely the same activities, and with precisely the same profit motives.

When government provides tax shelters for the profits of these exempt organizations, the government is fostering and supporting unfair competition against the tax-paying business firm.

It is not fair to permit the tax-exempt organization to run in the same competitive race with private enterprise, yet require private enterprise to drag a ball and chain.

> The fact that most private enterprisers have more than held their own in such an uneven race attests to the strength of the private enterprise system. But how many private enterprisers have been forced to give up because of the unfair conditions under which they were forced to compete?

Section 121 of H.R. 13270 is a constructive step because it strengthens private enterprise, the economic foundation of this nation.

B. Taxing Profits of Co-ops

Meaningful tax reform with respect to cooperatives is presented in S. 2646 (introduced by Senator Ribicoff). It puts the co-op on the same tax basis as other business enterprises, making the co-op fully taxable on the profits which

it earns. We endorse the provisions of S. 2646 with respect to cooperatives. We urge their substitution for Sec. 531 of H.R. 13270.

The impact on private enterprise from cooperatives is staggering. The Cooperative League of the USA boasts that:

...Co-ops are the source of about 20% of supplies for farmers;

...Mutual insurance is growing at about twice the insurance-industry rate;

...Credit unions account for about 12% --$9.2 billion -- of the installment credit outstanding in the United States;

...In addition farmers market about 30% of all their products through cooperatives;

...The co-op share of all marketing of farm products is --

67% of dairy products

38% of grain, soybeans

29% of fruit, vegetables

25% of cotton and products

14% of livestock and products

9% of poultry and products.

...The co-ops account in this country for

31% of all sales of fertilizer and lime

28% of all sales of petroleum products

22% of all sales of seed

19% of all sales of feed

16% of all sales of pesticides.

...Five co-ops are among the 500 largest U.S. corporations.

They are:

Name of Cooperative	Ranking Among Country's Corporations	Annual Volume
Agway Inc., Syracuse, N.Y.	188th	$520 million
Farmland Industries Kansas City, Mo.	244th	$378 million
Land O'Lakes Creameries Minneapolis, Minn.	251st	$367 million
Cotton Producers Association Atlanta, Ga.	312th	$272 million
Farmers Union Central Exchange St. Paul, Minn.	471st	$153 million

A partial indication of the growth of the co-op movement is reflected in the following compilation prepared by The Cooperative League of the USA.

Numbers, Members, and Business Volume of Cooperative and Mutual Organizations

(Figures are for latest available year)

KIND OF CO-OP	PURPOSE	NUMBER OF CO-OPS	INDIVIDUAL MEMBERS	DOLLAR VOLUME (thousands)	REMARKS AND SIGNIFICANT TRENDS
Consumer goods centers	Food and home supplies	826 (stores)	572,581	$ 753,884	Smaller co-op stores will be found throughout the nation, but especially in the Great Lakes area of Minnesota and Wisconsin.
Credit unions	Thrift and credit	23,287	19,870,000	11,300,000 (savings) 9,900,000 (loans outstanding)	Credit unions are expanding to provide full financial services, including travelers checks, money orders, even government securities. Number of credit unions increased by 515 in 1967.
Electric co-ops	Rural electricity	924	5,000,000	896,930	About 91% of the co-ops' meters are on farms and in churches, schools, and business and industries. Rural electric co-ops are leading the battle to achieve rural-urban balance.
Farm credit system					
Banks for co-ops	Credit for co-ops	13	3,000 (co-ops)	1,700,000	Volume figures represent loans made during fiscal year 1968, an increase of 11.3% over fiscal 1967. At the close of the fiscal year the system's net worth was $2 billion, only 6.5% of which was government capital.
Federal land bank assns.	Long-term farm credit	686	400,000	1,300,000	
Production credit assns.	Production credit	459	546,000	5,400,000	
Farm marketing	Higher returns for producers	5,100	3,700,000	12,850,000	About ⅗ of all farmers are members, marketing thru co-ops 25% to 30% of all they produce at some stage. Figures projected for 1967.
Farm purchasing	Production and home supply savings	2,900	3,060,000	3,225,000	Farmers purchase 20% of all farm production supplies from co-ops. Nonfarm persons also join to purchase home, garden supplies. Figures projected for 1967.
Farm service	Trucking, storage, ginning, grinding other services	180	35,000	330,000	In addition to co-ops primarily performing services, 60% of farm marketing and 53% of supply co-ops perform one or more services. Figures projected for 1967.
Group health plans	Prepaid health care	180	7,000,000	400,000	These include community, consumer, union and employee-employer sponsored plans. "Members" refers to individuals.
Housing	Homes	600	172,000	250,000	The $250,000,000 contains some payments for playgrounds, pools and other community facilities. "Members" refers to family units.
Insurance, co-op oriented	Financial security	15	11,850,000	776,200	In addition, there are hundreds of farmers' mutuals, workmen's benefit societies and other groups serving additional millions of members. Dollar volume is annual premium income.
Memorial societies	Dignified last rites	101	300,000	1,300	Dollar volume represents estimated savings to families. Some co-ops operate their own funeral facilities, but most contract with funeral directors or simply represent their members' wishes.
Nursery schools	Pre-school child care	1,440	72,000	6,000	Parents usually do part of the work in these cooperatives, thus sharing in child-raising experiences as well as saving money.
Student co-ops	Room and board, books, social activities	400	400,000	29,400	These estimates include cooperative book stores, as well as the houses in which students get room, or board or both.
Telephone co-ops	Rural telephone service	232	632,000	65,000	With 80% of America's farms now enjoying telephone service, phone co-ops emphasize upgrading service — reducing the number of party lines and parties on a line, providing dial service.

CO-OP REPORT, September 1968

The "big business" diversification aspect of the co-op is reflected in this report on one of the regional farm supply co-ops:

> "Midland Cooperatives' membership now numbers 300,000 families through 700 affiliated co-ops. Petroleum continued to be a major line, with refineries producing at almost 100% capacity. Fifty-one new wells were drilled. Fertilizer, seed and chemical sales showed a 20% jump. Midland's 170-unit trucking fleet is one of the nation's largest private carriers." (Source: CO-OP REPORT, Sept. 1968. Emphasis supplied.)

The shelter now provided special privilege organizations, such as the co-op, is leading to the destruction of the economic tax base of this country. The exemption is a cancer feeding on tax-paying business and on the federal revenue. The WALL STREET JOURNAL in discussing farm co-ops gave this correct analysis:

> "Thus the Government has created a kind of Gresham's tax law; the people who don't pay taxes drive out of business the people who do.
>
> "Aside from the economic unfairness of saddling one group of people with high taxes and granting another group of people the right to do the same business with no like taxes to pay, there is a question about the economic soundness of any such government policy.
>
> "Actually it comes down to this question: If all the taxpayers were driven out of business by non-taxpayers, who'd

pay the taxes?" (Source: Editorial, WALL STREET JOURNAL, 4-10-58.)

We favor the placing of co-ops on the same tax basis as other business enterprises, making them fully taxable on the income which they earn. Where those earnings are subsequently distributed to owner-patrons, the owners should be taxed the same as corporate dividends are now. Senator Ribicoff has proposed this in S. 2646, and we recommend your favorable consideration of his approach to the co-op problem.

In letters to the WASHINGTON POST published on Sept. 21, 1969, spokesmen for The Cooperative League of the USA and the National Council of Farmer Cooperatives criticized Sec. 531 of H.R. 13270 as "a punitive measure (which) takes away the right of co-op members to leave some of their funds in their co-op for growth needs and to provide development capital."

The WASHINGTON POST is to be commended for putting the taxation of co-ops in proper focus. In an Editor's Note, it correctly said:

"Co-operative corporations, under present law, avoid all tax liability by paying 20 per cent of their patronage dividends to members in cash. This gives the co-ops a competitive advantage because 80 per cent of earnings can be retained for reinvestment. But the member is liable on his personal income tax report for 100 per cent of his share of the earnings. The House, therefore, proposed that the co-ops be required to pay out an additional 30 per cent in cash (phased out over a 10-year period). This would make

it more likely that the patron would have enough cash to cover the tax liability on his total earnings, and at the same time would reduce the co-ops' retained earnings advantage. But what is actually needed beyond this first step toward equity is something like the Ribicoff bill, which would levy a tax on co-ops themselves, plugging a $200 million loophole." (Source: WASHINGTON POST, 9-21-69. Emphasis supplied.)

We believe the WASHINGTON POST has understated considerably the size of the loophole.

The public has the right to know how many tax dollars are being avoided by co-ops and other exempt organizations in direct competition with tax-paying businesses.

The facts -- not guesstimates -- are available to your Committee from the Treasury Department, the Internal Revenue Service, the Farmers Cooperative Service of the Department of Agriculture, the Bureau of Federal Credit Unions, and other governmental agencies.

C. How Can Congress Justify a Policy That Perpetuates Unfair Competition and Promotes Monopoly?

Regardless of the size of the loophole, there is a more important reason for plugging the loopholes now being exploited by exempt organizations, and that reason is: how can Congress justify on a factual basis a policy that is perpetuating unfair competition and promoting monopoly?

Our Association consists of 35,000 small business units.

They are taxpayers in more than 600 categories of busi-

ness -- manufacturing, wholesaling, retailing, professional, and service.

Exempt organizations are competing with these taxpaying business units for the same consumer's dollar. They perform the same commercial function as the taxpaying business unit. But because of their tax loophole, they pay relatively no taxes. Thus they can afford to cut prices to gain a greater stranglehold on the market; or they can use their profits for expansion; or they can use their profits to acquire competitors (primarily small business units). The end result is the same: less competition and a trend toward monopoly.

The immediate damage to small business, and to the public welfare, is obvious. The long-range damage to the private enterprise system, the economic foundation of this country, can be disastrous.

III. OUR PROPOSALS PROMOTE FISCAL SOUNDNESS

Although precise figures are unavailable to us, it is our belief that plugging only those loopholes mentioned in this statement would more than offset raising the surtax exemption from $25,000 to $100,000.

Fiscal soundness is essential to our nation and we propose nothing to weaken it.

On the contrary, we believe our proposals will strengthen fiscal soundness by encouraging a sound long-range build-up of a vital productive sector of our economy.

Thank you for the opportunity to present our views.

# # #

DIVISION OF FEDERAL TAXATION

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TESTIMONY ON TAX REFORM ACT OF 1969

PRESENTED TO SENATE COMMITTEE ON FINANCE

OCTOBER 2, 1969

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DIVISION OF FEDERAL TAXATION

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

ORAL TESTIMONY ON TAX REFORM
PRESENTED TO SENATE FINANCE COMMITTEE

OCTOBER 2, 1969

My name is Robert G. Skinner. I am a member of the Executive Committee of the Division of Federal Taxation of the American Institute of Certified Public Accountants. I am accompanied by Herbert Finkston a member of the Institute's tax staff. We are appearing here today on behalf of the Institute.

The AICPA is the sole national organization of professional CPAs. It was established in 1887 and currently has approximately 70,000 members.

We appreciate the opportunity to express our views on the vital issue of tax reform. We have prepared for consideration by your Committee a detailed analysis and a summary of our comments on selected provisions of H.R. 13270. In addition, it is our firm belief that any continuing effort in pursuit of tax reform at this time should also include consideration of substantive technical amendments of existing provisions of the Internal Revenue Code which perpetuate inequities, give unintended benefits and create unintended hardships. The Tax Division of the Institute has prepared a booklet entitled

"Recommendations for Amendments to the Internal Revenue Code" which lists and explains a number of substantive technical proposals which we believe should be enacted into law.

We would appreciate it if both our summary and detailed presentation together with our booklet and these oral comments are included in the record of these hearings.

While there was some disagreement within our Tax Division on the merits of various provisions of the House Bill, there was one conclusion on which agreement was unanimous -- the incredible complexity of the legislation. Provisions such as those dealing with private foundations, farm losses, the foreign tax credit and the limit on tax preferences will prove to be very difficult in application and administration. In many cases proposed changes contained in the Bill do not replace current sections of the law; instead, the new tax reform proposals would further complicate an already too complex self-assessment tax system.

One of the services performed by Institute members in their accounting practices is tax return preparation. CPAs probably prepare the bulk of tax returns filed in the United States which are not considered simple. We are seriously concerned that the overall effect of this reform Bill will be overwhelming and may even lead to noncompliance. We urge your Committee to carefully weigh the reform objectives sought here in light of the burden that the House proposals would impose upon this nation's taxpayers as they seek to interpret and comply with them.

In the remaining time available today, we would like to emphasize three additional measures that we feel should be included in any tax legislation approved by your Committee this year.

Taxation of Payments for Merchandise or Other Property Received Prior to the Occurrence of Sale

There has been a significant and widespread increase in the efforts of Revenue Agents to tax advance payments and deposits for both goods and services without regard to the matching of related costs and without regard to whether these advances are refundable. Adjustments of this nature proposed by Revenue Agents have been stimulated by a series of recent court cases in which the Commissioner has been sustained in taxing advance payments from the sale of goods rather than just the income from these sales.

In effect, these cases hold that upon receipt of the sales price, or any part of it, the amounts so received must be included in taxable income. Only when the merchandise is subsequently shipped or delivered, or title passes to the customer, is a deduction allowed for the related costs. The fact that these two events take place in different years, distorting the income of both years, has been disregarded. One Circuit Court has held that inclusion in gross income of the entire amount of advance payments, without an allowance for related cost of goods sold, would constitute taxation of the return of capital. Nevertheless, the Circuit Court affirmed the decision of the Tax Court because the taxpayer

did not establish an amount for the cost of goods sold applicable to the advance payments. The treatment that the courts have approved in this area violates the annual accounting concept which requires the matching of revenue with related costs and expenses. The courts have, in effect, completely disregarded this principle. The seriousness of this problem should not be underestimated. It is entirely possible that unless relief is granted in this connection, some manufacturers could be taxed out of existence.

Several years ago Congress assisted in the resolution of a similar problem. Automobile clubs had been accounting for dues revenue ratably over the period to which the dues applied. The Commissioner proposed that dues revenue should be recognized in the year received and that the related expenses should not be deductible until later years when they were actually incurred. The courts supported the Commissioner's treatment which was completely contrary to the accounting principle of matching revenue with related costs and expenses. As a result, section 456 was eventually enacted to remedy the problem. Code section 455 provides similar treatment for prepaid subscription income. Our Tax Division urges Congress to take similar action regarding the taxation of advance payments for merchandise.

We propose that section 451 of the Code be amended by adding a new subsection which would simply provide that

payments received for goods sold by a taxpayer in the ordinary course of trade or business shall be included in income in the year in which the sale takes place. For this purpose the method of accounting regularly employed by the taxpayer in keeping his books shall be determinative.

Alternatively, section 451 could be amended to make it clear that gross income from the sale of merchandise or other property is the gain from such a sale and not the gross receipts from the transaction.

Relaxation of Requirements for Advance Rulings Regarding Transactions Involving Foreign Corporations

Section 367 of the Code provides that certain provisions of Subchapter C (covering liquidations of controlled subsidiaries, transfers to controlled corporations, and specified reorganization exchanges and distributions) will not be applicable to foreign corporations unless prior to the transaction the Secretary of the Treasury or his delegate determines that the transaction "is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

The Secretary of the Treasury or his delegate should be given statutory authority to make a determination after an exchange that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Notwithstanding the similarity of purpose and structure of Code section 367 and sections 1491 and 1492, section 1494(b) provides that the tax otherwise imposed by section 1491 may be abated, remitted or refunded if, after the transfer, it is established to the satisfaction of the Secretary or his delegate that the proscribed tax avoidance purpose did not exist. Legislative history discloses no reason for withholding similar relief from the impact of section 367 which, because it requires a ruling in advance of the exchange, has been and continues to be a trap for the unwary.

Moreover, recent experience has indicated that rulings under section 367 have been delayed for six months and longer -- even where the Internal Revenue Service has agreed to expedite the case -- resulting in expensive harships for taxpayers.

Amortization of Intangible Assets

The cost of purchased goodwill, trademarks, trade names, secret processes, formulas, licenses and other similar intangible assets should be amortizable over a stated period fixed by statute to the extent that these costs are not otherwise deductible under other sections of the Code.

Under present law, a taxpayer can amortize costs of this nature only if a definitely determinable useful life can be established or, failing that, upon proof of the abandonment of the asset. Many court decisions and Internal Revenue Service

rulings have held that no amortization is allowable where these tests are not met -- even though the value of the intangible asset obviously has been impaired.

We recommend an amendment of the Code to provide that if a definite life cannot be determined for a purchased intangible asset, its cost can be amortized over a period of 120 months or, at the election of the taxpayer, over a longer period.

Section 1245 should provide, if it does not now do so, for recapture of amortization when the intangible asset is sold or otherwise disposed of in a transaction covered by that section.

* * * *

We have presented our recommendations with the hope that they will prove helpful. If it should appear that our Tax Division could assist you or your staff in your analysis of the various proposals, we would be pleased to do so in any way that you wish. We appreciate this opportunity to present our comments to you.

SUMMARY OF COMMENTS ON H.R. 13270
THE TAX REFORM ACT OF 1969

This summarizes our views on selected provisions of H.R. 13270. The Division of Federal Taxation supports many of the provisions of the Bill. This summary will be confined to those provisions where difficulties are perceived.

Private Foundations

While we agree with the intention of the Bill to curb abuses by private foundations, we are unable to express a consensus of opinion on the provisions of the Bill regarding private foundations. However, we do support the prohibitions on self-dealing.

The Bill in this area is comprehensive and extremely complex. So much so that it is difficult to determine whether the abuses sought to be corrected will be accomplished without unnecessarily restricting the appropriate activities of private foundations. Equally difficult to determine without extensive analysis are the socio-economic consequences which may result from the enactment of the present provisions of this Bill.

Notwithstanding our inability to express a consensus of opinion on the private foundation provisions of the Bill, we hope that the following suggested modification will assist your Committee to properly evaluate the House proposals in this area.

1. The tax on investment income should be limited to the extent it is intended to raise revenue. It should not be imposed as a "user" fee.
2. While it is difficult to object to the imposition of the proposed tax on termination of exempt status for willful repeated acts or for a willfull and flagrant act (proposed Code section 507), the computation of the aggregate past tax benefits is too

complicated and seems unnecessary in view of the circumstances under which the tax would be imposed.

3. The tax on failure to distribute (proposed Code section 4942) requires that allowance for amounts set aside for future projects be established to the satisfaction of the Internal Revenue Service at the time they are set aside. In view of the penalties for failure to distribute, the Service will be able to prevent the setting aside of amounts merely by failing to act on applications or through the manner in which information supporting the amounts set aside is required to be filed. Foundations should be permitted to support these "set-asides" later.
4. The Bill limits to 20 percent the combined ownership of the corporation's voting stock which may be held by the foundation and all disqualified persons. We believe that this percentage limitation should be 35 percent.
5. The tax on investments which jeopardize charitable purposes (proposed Code section 4944) is too punitive considering the subjective nature of the act that would give rise to the tax. Any investments that experience a loss in value would

be regarded by some as having jeopardized the exempt purposes. As a minimum, there should be a "correction period" as provided in proposed Code section 4941 (e)(4).

6. The attribution rules included in proposed Code section 4946(a)(3) for determining "disqualified persons" should be modified to follow the rules of section 318(a) rather than Code section 267(c), or section 267(c)(3) should be modified to apply only to partners having an interest of 10 percent or more.

Other Exempt Organizations

1. Clay B. Brown Case

Section 121(d) of the Bill is intended to deal with the Clay B. Brown problem. However, it seems unnecessarily harsh in attempting to tax all debt-financed income. As an alternative, the present exemption from the unrelated business income tax for rents from personal property leased with realty could be eliminated. This would prevent Clay Brown-type transactions by taxing the rent from any lease for whatever term where personal property constitutes more than an incidental or insubstantial portion of the property subject to the lease.

2. Extension of Unrelated Business Income Tax

The Bill would extend the tax on unrelated business income to additional exempt organizations, including churches, social welfare organizations, social clubs and fraternal

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beneficiary societies. To the extent these organizations operate business enterprises that are unrelated to their exempt purposes, they are permitted to compete unfairly with taxable entities. We support the extension of the tax in these circumstances; however, we recommend that the specific deduction allowed in the determination of unrelated business income be raised from $1,000 to $5,000. This should eliminate much of the burden of compliance by the organizations and audit by the Internal Revenue Service.

In the case of social clubs, the Bill proposes that income from nonmember activities should be taxed. Allocation of income and expenses between member and nonmember activities will present difficult accounting and definitional problems that should be provided for more clearly.

3. Advertising Income Derived From Periodicals of Exempt Organizations

Section 121(c) of the Bill proposes to make clear that the regulations promulgated in December 1967 by the Treasury Department are in accordance with the intent of the present Congress. We believe that these regulations, in which the advertising activities of a periodical published by an exempt organization are singled out for treatment as an unrelated business, are unrealistic in concept. Further, we believe that it is possible for both the advertising and editorial content of certain of these periodicals to be functionally related to the exempt purposes of the organization. Accordingly, we believe that section 512 or 513 should be amended to incorporate the following concepts:

a. A trade or business should be defined along vertically integrated lines so that advertising activity, alone, cannot constitute a trade or business.

b. If the activities of such defined trade or business are functionally related to the purposes for which an organization has been granted exemption, this trade or business should not be characterized as unrelated to the exempt purposes of the organization.

This approach should prevent the unfair competition that was the original target of Congress in enacting the tax on unrelated business income.

Charitable Contributions

With respect to sections 201(c) and (d) of the Bill regarding charitable contributions of appreciated property, we do not favor the distinction drawn between gifts to public and gifts to private foundations. It is our view that contributions of such property should be treated in the same manner without regard to the type of charitable recipient.

Farm Losses

We agree with the intended purpose of the proposed legislation to curb abuses of capital gain provisions coupled with the use of losses from farming operations. On the other hand, we believe that the language of section 211 of the Bill is so sweeping that it will affect more taxpayers than intended.

To illustrate, section 211 applies to all taxpayers who, with respect to any taxable year, (1) incur a farm net loss, or (2) have a balance in the excess deductions account at the close of the taxable year. An addition to the excess deductions account for a current year's farm loss is not required if (1) nonfarm adjusted gross income is $50,000 or less, and (2) the farm net loss is $25,000 or less. However, it appears that the $50,000/$25,000 de minimis exceptions do not apply to excuse application of section 211 in the face of a current year's loss, no matter how small (proposed Code section 1251(a)(1)). Should this be the case, section 211 would apply to all taxpayers incurring a current farm loss, with the result that a great many farmers would be faced with loss of capital gain benefits if they did not elect to adopt certain accounting methods.

To remedy this apparent defect, we recommend that the Bill be clarified so that there is no doubt that the $50,000/$25,000 de minimis exceptions apply also in the case of farm net losses for the current taxable year.

Hobby Losses

We agree with the intended purpose of the proposal for dealing with so-called hobby losses. In our judgment, however, the proposed provisions should be modified to the following extent:

1. The $25,000 excess of deduction over gross income should be changed to $50,000 (proposed Code section 270(b)).

2. Wherever it appears throughout the section, the term "activity" should be changed to "trade or business"
3. The application of this proposal should be limited to individual taxpayers.

Limitation on Deduction of Interest

We do not agree with the proposed limitation on the deduction of interest on funds borrowed for investment purposes. It has long been an established general principle of economics, accounting and taxation that express incident to the production of income are deductible from such income. This legislative proposal in a sense represents an artificial and arbitrary mutation of this principle which would tend to discourage the assumption of risk and the investment of capital -- both of which have been important factors in the growth and development of our economic system. Furthermore, it would constitute an inconsistent exception to the cash receipts and disbursements method of accounting under which expenses are deducted when they are paid and income is taxed when it is received.

If, however, this proposed amendment of the Code is enacted in basically its present form, it is suggested that the limitation be made applicable at both the corporate and the shareholder level in the case of Subchapter S corporations.

Moving Expenses

The Bill modifies the present treatment of job-related moving expenses by broadening the categories of deductible

moving expenses, by providing that reimbursed employees are to be treated in the same manner as unreimbursed old employees and new employees, and by refining the requirements which must be met for the deduction to be available. We believe that the dollar limitations on amounts of certain of these deductions are unrealistic in today's economy and that they should be increased. We also believe that the deductions provided for should be extended to self-employed taxpayers and to partners.

Furthermore, we urge that the moving expense proposals be made effective for taxable years beginning on or after January 1, 1964.

Limit on Tax Preferences

The provisions of the Bill placing a limit on tax preferences would impose a tax by indirect means on amounts which presently are fully or partially tax exempt. We agree that public confidence in our self-assessment system is undermined by the ability of individuals to realize large amounts of disposable income with little, if any, payment of tax. However, we recommend that the tax preference items be dealt with through direct legislation. If this is not practicable, then we would support the provisions of the Bill with one modification. The tax preference item regarding the excess of accelerated depreciation over straight line depreciation should likewise provide for a reduction when straight line depreciation exceeds accelerated depreciation.

Income Averaging

Section 311 of the Bill would liberalize current law by reducing the requirements regarding the amount of income which qualifies for averaging and also, by broadening the types of income which are eligible for averaging.

We support this provision of the Bill but take exception to the proposed effective date of taxable years beginning after December 31, 1969. We note that the provisions of the Bill dealing with the repeal of the alternative tax on capital gains for individuals (section 511) are to be effective with respect to sales and dispositions occurring after July 25, 1969. The effective dates of these two provisions coupled with the 10 percent tax surcharge now in effect subjects any long-term capital gain realized by individuals in the brief period from July 26 to December 31 to a severe and inequitable tax penalty. We believe equity dictates that the effective dates for eliminating the alternative capital gains tax and introducing the new averaging provisions be the same.

Restricted Property

Section 321 of the Bill provides that a person who receives a beneficial interest in property by reason of services performed is to be taxed with respect to the property at the time it is received if he can transfer the property and if it is not subject to substantial risk of forfeiture. The tax will be on the amount by which the fair market value of the property exceeds the amount the employee paid for it.

At present the treatment of restricted property is governed by regulations which provide for no tax when the employee receives the restricted stock. When the restrictions lapse, the value of the stock at the time of transfer to the employee (determined without restrictions) is treated as compensation provided it has increased in value. If the value decreases, then the lower value is considered the compensation.

We support this provision on condition that any legislation finally approved continues to provide for the 50 percent maximum rate on earned taxable income. This provision, coupled with the capital gain provisions in the Bill, reflects a recognition of equality of tax treatment between earned income and capital gain income. We believe that these provisions, taken together will continue to provide incentive for those who have contributed much to our economic progress and will also lessen the search for transactions motivated by tax avoidance.

Accumulation Trusts, Multiple Trusts, etc.

We generally support the provisions of the Bill applicable to trusts except for effective dates. We recommend that the restrictive changes proposed with respect to accumulation trusts be made applicable only to those trusts established or additions made to the corpus of existing trusts after April 23, 1969.

With respect to eliminating the exceptions available under the definition of "accumulation distribution" as contained in present section 665(b) of the Code, it is recommended that for those accumulation trusts which cannot qualify under these

exceptions, the effective date with respect to full or maximum throwback apply only to accumulations in fiscal years ending after April 23, 1969.

Corporate Mergers

We disagree with section 411 of the Bill, which provides that a corporation is not to be allowed an interest deduction with respect to certain types of indebtedness. It is our view that any restrictions on the "tide of conglomerate mergers" should be imposed outside the tax law.

More specifically, we feel that the criteria contained in proposed Code sections 279(b) and (c) are arbitrary and of doubtful validity, and the $5 million amount contained in proposed section 279(a) is discriminatory. Other difficulties may involve tracing problems and the question of what constitutes a "plan" of acquisition. Finally, the proposal will adversely affect persons who for valid business reasons may desire to sell their businesses. Such persons may be unable to realize a proper price because of the depressing effect of the proposal.

We disagree with section 412 of the Bill to the extent proposed section 453(b)(3) will disqualify from installment sale treatment transactions which presently have good business purpose. It would add more uncertainties to an already difficult area. Furthermore, problems presented by extensions, calls or other modifications are not covered. It is our view that proposed section 453(b)(4), with which we concur, is adequate to cover present abuses of the installment method.

We also do not agree with section 413 of the Bill regarding the tax treatment of original issue discount on bonds. We feel that the proposed changes violate the well-established rules of the cash method of accounting and further that they will add to complexity and information reporting difficulties far out of proportion to the problem which section 413 is designed to solve.

We recommend as an alternative solution of the problem that present Code section 1221 be amended to exclude from the definition of a capital asset all corporate nonconvertible debt (sometimes referred to as "straight" debt). Such a provision would make all gains and losses on sales of nonconvertible corporate debt ordinary income or ordinary deductions, respectively.

Nonconvertible corporate debt is acquired by an investor for the principal purpose of realizing a yield on the money invested. It appears that the market value of nonconvertible corporate debt obligations fluctuates in large measure with reference to prevailing interest yields. Accordingly, it seems reasonable to tax as ordinary income or allow as ordinary deductions gains or losses on disposition of the obligations which are primarily mere adjustments of yields.

We recognize that changes in market value of nonconvertible corporate debt can also be attributable to a change in the credit rating of the issuer, and it is true that it might be appropriate to reflect this element as capital gain or loss. However, on balance, we feel that the treatment of nonconvertible corporate

debt as a noncapital asset will eliminate or reduce the importance of many complexities, including those resulting from sections 171 and 1232 of the Code.

Natural Resources--Mineral Production Payments

We recommend that an exception to the treatment of mineral production payments as loans be made for production payments used to equalize the investment of participants in a unitization.

Natural Resources--Mining and Exploration Expenditures

We support the provisions of the Bill dealing with exploration expenditures. We suggest, however, that a provision be added to permit taxpayers who have made elections under present law to have additional time to make new elections. Present section 615(f) may prohibit this.

Capital Gains and Losses

Section 514 of the Bill provides that long-term capital gain is to be a gain from the sale or exchange of a capital asset held for more than 12 months rather than the present 6 months. Gains realized on the sale or exchange of capital assets held for not more than 12 months are fully taxable as ordinary income.

Admittedly, the proposed 12 month holding period is arbitrary. We do feel however, that it is desirable to lengthen the six month period. We believe that a holding period beyond six months would more accurately indicate the intention to invest and thereby serve more closely Congressional

intent that special tax treatment be afforded gains from investment as distinguished from speculative gains.

The effective date for the capital gain and loss provisions of the Bill is generally July 25, 1969. This date can impose serious tax penalties for those sales or dispositions which are made after July 25, 1969 pursuant to action taken prior to that date. We therefore suggest that the effective date be established at December 31, 1969, or, in the alternative, eliminate from the provisions of the Bill any transactions to which the seller was committed in writing on or before July 25, 1969. Further, we suggest that insofar as the repeal of the alternative capital gains tax for individuals and the character of the gain is concerned, collections or other dispositions in connection with transactions in which the installment method was elected should be treated as if they occurred on or before July 25, 1969.

Subchapter S Corporations

We have previously expressed our support for the principle of conforming the treatment of Subchapter S corporations more closely to that accorded partnerships, and we believe that an overall revision of the Subchapter S rules is desirable. The Bill's treatment of contribributions to retirement plans in our judgment is an improper approach to only one Subchapter S corporation tax policy matter. We suggest that a better policy would be to amend the H.R. 10 rules to conform them more closely with those accorded corporations. Alternatively, no action should be taken on this matter until the overall revision of

Subchapter S is further considered.

We suggest a more convenient method be provided for handling forfeitures applicable to contributions for years beginning after 1969.

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DETAILED ANALYSIS AND COMMENTS ON SELECTED PROVISIONS OF H.R. 13270

This detailed analysis contains our comments on selected provisions of H.R. 13270. Our failure to comment on certain sections of the Bill does not mean that we approve them. Generally, absence of comment means that we have not been able to arrive at a consensus.

SECTION 101 OF THE BILL

PRIVATE FOUNDATIONS

Proposed Change

The Bill would provide rules for dealing with the following: tax on investment income, prohibitions on self-dealing, distributions of income, stock ownership limitation, limitations on use of assets, other limitations, disclosure and publicity requirements, change of status, changes in definitions, private operating foundation definition, and hospitals.

AICPA Comments

While we agree with the intention of the Bill to curb abuses by private foundations, we are unable to express a consensus of opinion on the provisions of the Bill regarding private foundations. However, we do support the provision regarding self-dealing.

Generally, the provisions of the Bill regarding private foundations are so comprehensive and extremely complex that it is difficult to determine whether the abuses sought to be corrected will be accomplished without unnecessarily restricting appropriate activities of private foundations. Equally difficult to determine without extensive analysis are the socio-economic consequences which may result from enactment of the present provisions of this Bill.

Notwithstanding our inability to express a consensus of opinion on the private foundation provisions of the Bill, we hope that the following suggested modifications will assist your Committee as it considers these provisions.

Section 101(a) of the Bill; Proposed Code Section 506

Tax on Investment Income

New section 506 of the Internal Revenue Code would provide for the imposition of a tax on the net investment income of every private foundation in an amount equal to 7-1/2 percent of such income. The House Committee Report states that since the benefits of government are available to all, the costs should be borne at least to some extent by all of those able to pay and that this concept is as applicable to private foundations as it is to taxpayers generally. The Committee then goes on to state that appropriate assurances are needed that private foundations will promptly and properly use their funds for charitable purposes. This tax in their view is deemed in part as being a user fee.

If we accept the concept that this tax is needed for purely revenue purposes, it might be difficult to argue against its imposition. But, if we are more concerned with "assurances that private foundations will properly use their funds for charitable purposes," such aims can be attained by proper supervision, administration and review; and there is no need to impose any tax. If we accept the latter view, such a tax should not be imposed as it would deprive private foundations of funds that would otherwise be available for charitable purposes.

Section 101(a) of the Bill; Proposed Code Section 507

Tax on the Termination of Private Foundation Status

Proposed Code section 507 provides in part that where there are willful repeated acts or a willful and flagrant

act, the Internal Revenue Service can terminate the exemption of a private foundation. Under these circumstances there is a tax imposed on such an organization, the lower of either the "aggregate tax benefit" or the value of the net assets of such foundation. While it is difficult to object to the imposition of the proposed tax, where the foundation has been in existence for a number of years it would be a massive job to prepare all of the required computations for all the different years with the different tax brackets and tax rates in order to determine the "aggregate tax benefit." Subsection 507(e) provides for abatement, which under proper circumstances should provide sufficient protection against undue taxation.

Section 101(b) of the Bill; Proposed Code Section 4942 Distributions of Income

The tax on failure to distribute (proposed Code section 4942) requires that allowance for amounts set aside for future projects be established to the satisfaction of the Internal Revenue Service at the time they are set aside. In view of the penalties for failure to distribute, the Service will be able to prevent the setting aside of amounts merely by failing to act on applications or through the manner in which information supporting the amounts set aside is required to be filed. Foundations should be permitted to support these "set-asides" later.

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Section 101(b) of the Bill; Proposed Code Section 4943

Excess Business Holdings

There may be a conflict of interest in some situations where stock of a closely-held corporation is donated to a private foundation. This situation generally does not exist in a 20 percent ownership situation. Even if a 20 percent interest constitutes effective control, there is not necessarily any more conflict of interest between the donor and the foundation than between the donor and the other shareholders.

We believe, as did the Senate in 1950, that the loss to charity which will result from this approach will exceed any tax avoidance which may be eliminated. Elimination or extended deferral of income and estate tax deductions in the instances indicated will not only remove a factor which encourages contributions, but will also eliminate the ability of some individuals, such as business men who own little of value outside of their business interest, to make contributions.

Tables 10 and 11 (on pages 79 and 83)of the Treasury Department's Report on Private Foundations dated February 2, 1965 disclose that this proposal could affect 8 out of every 10 foundations in existence. Of more importance, these tables show that the performance of foundations with more than 20 percent donor-related influence over investment policy is generally just as good as that of foundations with a lesser degree of control. The following are some relevant ratios:

Percent of Donor-Related Influence Over Investment

	Not over 20 percent	Over 20 percent	Over 50 percent
Ratio of market value of net assets to book value	144%	141%	132%
Ratio of ordinary income to market value of net assets	4.0	3.5	3.5
Ratio of contributions received to market value of net assets	3.1	7.7	9.8
Ratio of grants made to market value of net assets	6.0	6.9	7.8
Ratio of grants made to ordinary income	151	197	222

We suggest that any rule restricting investment holdings be limited to 35 percent or more interests.

Section 101(b) of the Bill; Proposed Code Section 4944

Investment Jeopardizing Exempt Purpose

The prohibited transaction covered by this proposed new section of the Code substantially paraphrases the language contained in the present Code section 504(a)(3). In both cases the language is not precisely definitive and inadvertent violation could occur, since an investment that jeopardizes the exempt purpose is a highly subjective concept. The proposed penalty for an inadvertent error is too punitive and such a penalty should only be imposed after the expiration of a "correction period" of a nature similar to that set forth in proposed Code section 4941(e)(4).

Section 101(b) of the Bill; Proposed Code Section 4946(a)(3)

Attribution Rules

This proposed subsection provides for the attribution rules of Code section 267(c) to apply to indirect stockholdings for the purposes of determining who is a "disqualified person" within the meaning of proposed Code section 4946(a). These attribution rules, and more specifically those of Code section 267(c)(3), are probably too broad and could result in violations from relatively minimal relationships. For example, Corporation A is a substantial contributor to Foundation F; X owns 50 percent and Y owns 1 percent of the combined voting power of A; X and Y, both individuals, are each 1 percent partners in a widely-held joint venture. Y has no other relationship with X, A or F, and yet it appears that he would be considered to be a "disqualified person" with respect to F.

It is suggested that the attribution rules of Code section 318(a) be substituted for those of section 267(c). In the alternative, it is suggested that the attribution rules of section 267(c)(3) only apply to partners with a partnership interest of 10 percent or more.

SECTION 121 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 512 AND 514

EXEMPT ORGANIZATIONS--DEBT-FINANCED PROPERTY

Present Law

Under present law, charities and some of the other types of exempt organizations are subject to tax on rental income from real property to the extent the property was acquired with borrowed money. However, this provision does not apply to all tax-exempt organizations and there is an important exception which excludes rental income from a lease of 5 years or less. Nor does the tax apply to income from the leasing by a tax-exempt organization of assets constituting a going business.

As a result some tax-exempt organizations have used their tax-exempt privileges to buy businesses and investments on credit.

Proposed Change

The Bill amends the Code to provide that all exempt organizations' income from "debt-financed" property is to be subject to tax in the proportion the property is financed by debt. Thus, for example, if a business or investment property is acquired subject to an 80 percent mortgage, 80 percent of the income and 80 percent of the deductions are taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes. Capital gain on the sale of debt-financed property is also taxed. The

amendment makes exceptions for property to be used for an exempt purpose within a reasonable time, and also for property acquired by gift or inheritance under certain conditions.

AICPA Comments - General

The Supreme Court decision in the Clay B. Brown case has focused attention on an abuse of tax exemption for foundations through their activities in debt financing of acquisitions.

The problems which may arise in borrowing by foundations for investment purposes are:

1. Private parties are able to shift a substantial measure of the financial benefit of the foundation's tax exemption to themselves (the so-called "bootstrap" sale); and
2. The private foundation can convert its tax exemption into a self-sufficient device for the production of capital, thereby severing itself from reliance upon contributions and eliminating the healthful scrutiny of its activities which is implicit in such reliance.

It is believed that H.R. 13270 goes significantly beyond what is necessary to deal with a Clay Brown-type transaction. It embraces the concept that virtually any type of income derived by an exempt organization from the use of borrowed funds should be taxed differently than the same or similar income derived from the use of corpus.

We urge that the scope of the Bill be limited to the avowed purpose of extending the unrelated business taxable income concept to income arising from Clay Brown-type transactions. Thus, the present exemption from tax on unrelated business income for rents from personal property leased with realty could be eliminated, assuming the personal property constitutes more than an incidental or insubstantial portion of the property subject to the lease. In effect, the leasing of personal property would be treated as an unrelated trade or business.

The following comments are submitted in the event that your Committee believes the "Clay Brown" provisions of H.R. 13270 should be enacted substantially as passed by the House. As indicated above, we believe that the general scope of this legislation is too broad.

Specific Comments

Proposed Code Sections 514(a)(1), 514(b)(1) and 514(c)

General

The proposed rules may subject an exempt organization to a tax liability under circumstances where no tax avoidance or genuine "debt-financed" acquisition is involved, and where we are sure no tax is intended to apply. Assume that an individual owns stock (or land, or any other property) with a basis of $3,000, subject to a loan (less than 5 years old) of $3,000, with a current value of $10,000. He makes a charitable contribution of the property subject to the loan. The recipient charity puts the property up for sale promptly.

In due course it is sold, the loan paid, and the remaining proceeds (the charitable contribution received) applied to charitable purposes. There will be a basis of $3,000 and an acquisition indebtedness of $3,000. The percentage described in section 514(a)(1) will be 100 percent. The gain of $7,000 ($10,000 proceeds less $3,000 basis) will therefore be fully taxable--surely an unintended result. The same result might even follow in the frequently arising situation where a charitable donor sells property to a charity at a bargain price. The purchase price itself, if it remains unpaid for only a few days, could be "acquisition indebtedness." To prevent this result, it should be provided that property acquired by gift, inheritance or bargain purchase shall not be treated as "debt-financed property" if the exempt organization, within a short time after acquisition, takes bona fide steps to dispose of the property and does in fact dispose of it within a time which is reasonable, taking into account the nature of the property.

Proposed Code Section 514(c)(7)

Acquisition Indebtedness

In computing the percentage of any gain or loss to be taken into account upon a sale or other disposition of debt-financed property, the term "average acquisition indebtedness" should be defined in a manner parallel to that in which it is defined for other purposes, i.e., the

average amount of the acquisition indebtedness during the 12-month period ending with the date of the sale or other disposition. It appears inequitable to use the highest amount of acquisition indebtedness during the 12-month period.

Proposed Code Section 514(b)(2)

Definition of Debt-Financed Property

The requirement that the tax be paid currently subject to later refund if the conditions of proposed section 514(b)(2)(B) are met, may harm some exempt organizations. For example, a university may be struggling under the financial burden of relocating its campus, or may be establishing another campus, and cannot meet the "neighborhood test." It does actually satisfy the "use test" within ten years. If the university must pay tax on income earned from the property, it may be seriously handicapped if it depends upon the earnings to help finance the project. The later refund does not make the university whole, because it may have needed the money earlier. It is suggested that where the circumstances contemplated by subparagraphs (B) and (D) arise, provision be made for disclosure requirements, for holding open the statute of limitations for assessment and for payment of the tax if the conditions are ultimately not met. Interest at the rate of 6 percent would, of course, be payable.

Proposed Code Section 514(b)(2)(D)

Definition of Debt-Financed Property

If this section is not revised in accordance with the immediately preceding recommendation, the rate of

interest on any overpayment should be the regular rate of 6 percent. There is no reason for the lower rate of 4 percent.

The reference in section 121(d)(2)(A) of the Bill on page 106, line 6 should be to "Section 514(b)," not to "Section 514(c)."

Proposed Code Section 514(c)(6)

Acquisition Indebtedness

This subsection provides that "acquisition indebtedness" does not include an obligation to the extent insured by the Federal Housing Administration. While this relief may be commendable from a social point of view, it raises the question why other perhaps equally worthy loans are not granted equal relief. On the other hand, it might be asked why any relief should be given at all if the true purpose of the Bill is to prevent the acquisition of income-producing assets by exempt organizations through the use of borrowed funds.

Proposed Code Section 514(d)

Basis of Debt-Financed Property Acquired in Corporate Liquidation

It appears grossly inequitable to deny to an exempt organization the benefits of section 334(b)(2) and to deprive it of the tax benefit of costs which it has actually incurred in acquiring the property.

Proposed Code Section 514(b)(1)(A)

Definition of Debt-Financed Property

It would seem too restrictive to bring within the scope of taxation and the resulting required allocations property acquired for the use and purpose of the exempt

organization as to which nonrelated rentals are incidental and possibly temporary in nature. Therefore, we recommend that the word "substantially" be inserted before the word "all" in the first line of proposed section 514(b)(1)(A).

SECTION 121 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 511 AND 513

EXEMPT ORGANIZATIONS--EXTENSION OF UNRELATED BUSINESS INCOME TAX

Present Law

Under present law the tax on unrelated business income applies only to certain tax-exempt organizations. These include:

1. Charitable, educational, and religious organizations (other than churches or conventions of churches);
2. Labor and agricultural organizations;
3. Chambers of commerce, business leagues, real estate boards, and similar organizations;
4. Mutual organizations which insure deposits in building and loan associations and mutual savings banks; and
5. Employees' profit sharing trusts and trusts formed to pay (nondiscriminatory) supplemental unemployment compensation benefit.

Proposed Change

The Bill extends the unrelated business income tax to all exempt organizations (except United States instrumentalities created and made tax exempt by a specific act of Congress). The organizations which will newly be made subject to this tax include churches and conventions or associations of churches, social welfare organizations, social clubs, fraternal beneficiary societies, voluntary employees'

beneficiary organizations, teachers' retirement fund associations, benevolent life insurance associations, cemetery companies, credit unions, mutual insurance companies, and farmers cooperatives formed to finance crop operations.

As under present law, in general this tax does not apply unless the business is "regularly carried on" and therefore does not apply for example in cases where income is derived from an annual athletic exhibition. Under the amendments made by the Bill, in the case of any membership organization, any income resulting from charges to the members for goods, facilities, and services supplied in carrying out the exempt function is not subject to tax.

The Bill contains several administrative provisions including one providing that no audit of a church is to be made unless the principal Internal Revenue officer for the region believes that the church may be engaged in a taxable activity. Churches will not be subject to tax for six years on businesses they now own.

AICPA Comments

We believe that the principal aim of any reform in the tax treatment of exempt organizations should be to make sure that they shall have neither an advantage nor a handicap in those operations in which they are competing with taxpaying organizations. The Congress has long recognized that a tax-exempt organization has an inherent advantage over a taxpaying organization if both are competing in the same field. Therefore, in 1950, Congress enacted a tax on the

unrelated business income of some but not all exempt organizations.

H.R. 13270 provides that the unrelated business income tax be extended to apply to a number of additional types of exempt organizations. These include churches (or associations of churches), social welfare organizations, social clubs, and fraternal beneficiary societies. Certain exceptions and limitations are provided in each case to protect exempt activities from taxation.

We support these provisions. There appears to be no reason why a church, for example, should be permitted to engage in activities not related to its exempt purposes so as to compete on a tax-exempt basis with a taxpaying enterprise. Any such tax preference tends to impair the proper working of our free market economy which is based on open and fair competition.

Section 121(b) of the Bill; Proposed Code Section 512(a)(3)
Social Clubs

At present social clubs are not subject to the unrelated business income tax. An incidental sale of property will not deprive the social club of its exemption, but a club which regularly receives income from sources other than its membership will generally lose its exemption regardless of whether the outside income is from investments or from a business activity. Thus, social clubs which receive any nonmembership income are currently in an all-or-nothing quandary. If the outside income is an incidental item the club remains

exempt and the outside income escapes taxation. If the item is more than incidental the club becomes fully taxable. It is often hard to draw the dividing line.

The Bill provides that social clubs be taxed on all their income, whether from investments or other sources, except that which is derived from the members in return for the club's services as a social club. The proposed taxation of investment income is intended to prevent untaxed investment income from indirectly inuring to the members' benefit by subsidizing the club's services to the members.

We support this provision subject to the following recommendations:

1. The Bill would allow as deductions, items directly connected with an activity generating income subject to tax. This could give rise to considerable controversy as to what is directly connected. In any case it is inequitable because clearly a portion of the indirect or overhead expenses of the club are also connected with the income subject to tax. Accordingly, the deductible items should be defined as including direct expenses and an allocable portion of the indirect or overhead expenses.
2. It should be made clear that a club is entitled to the same deductions as any other taxpayer with respect to its income subject to tax. Thus, it should be entitled to deductions

for depreciation, interest, taxes, repairs, etc., with respect to rental income; the dividends received deduction; and to deduct all expenses connected with income-producing property. It should also be made clear that clubs are entitled to the benefit of the tax-free exchange provisions and the involuntary conversion provisions.

3. If a club disposes of the property used in its social functions, either to move to a new location or to construct new facilities, it should not be taxed on the gain from such disposition so long as the proceeds are reinvested in other facilities to be used in its social functions.

<u>Section 121(b) of the Bill; Proposed Code Section 512(b)(12)</u>
<u>Limit on Specific Deduction</u>

We recommend that the specific deduction under section 512(b)(12) be raised from $1,000 to $5,000. This will recognize the inflation that has occurred since enactment of the tax on unrelated business income and eliminate the compliance burdens of exempt organizations having similar amounts of unrelated income. (See Technical Information Release No. 899, April 14, 1967, which announced the proposed regulations under sections 512 and 513 and indicated that the

Internal Revenue Service would consider the appropriateness of a legislative recommendation to make the tax inapplicable where only "small" amounts of unrelated income are involved.)

Section 121(b) of the Bill; Proposed Code Section 512(b)(15) Special Rules for Certain Organizations

Under proposed Code section 512(b)(15), passive type income received from organizations over which the recipient exempt organization has control (as defined in section 368(c)) are included in the exempt organization's unrelated taxable income. This 80 percent control requirement may not be sufficiently stringent to carry out the Congressional purposes since it may permit easy avoidance. A lower percentage may be appropriate.

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SECTION 121--PROPOSED AMENDMENT TO CODE SECTION 512

EXEMPT ORGANIZATIONS--TAXATION OF INVESTMENT INCOME OF SOCIAL, FRATERNAL AND SIMILAR ORGANIZATIONS

Present Law

Under present law the investment income of social clubs fraternal beneficiary societies and voluntary employees' beneficiary associations are exempt from income tax.

Since the tax exemption for social clubs, fraternal beneficiary societies and voluntary employees' beneficiary associations is designed, at least in part, to allow individuals to join together to provide recreational or social facilities without tax consequences, the tax exemption operates properly only where the sources of income of the organization are limited to receipts from the membership. Where an organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit from the tax-exempt funds used to provide pleasure or recreational facilities.

Proposed Change

The Bill provides for the taxation (at regular corporate rates) of the investment income and other unrelated income of social clubs, fraternal beneficiary associations, and voluntary employees' beneficiary associations. This will not apply, however, to such income of fraternal beneficiary associations and voluntary employees' beneficiary associations to the extent it is set aside to be used only for the exempt insurance function of these organizations and for charitable purposes.

If in any year an amount is taken out of the set-aside and used for any othor purpose, the amount taken out will be subject to tax in such year.

We support this proposed amendment to the Code.

SECTION 121 OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 512

EXEMPT ORGANIZATIONS—INTEREST, RENT AND ROYALTIES FROM CONTROLLED CORPORATIONS

Present Law

Under present law, rent, interest and royalty expenses are deductible in computing the income of a business. On the other hand, receipt of such income by tax-exempt organizations generally is not subject to tax.

Some exempt organizations "rent" their physical plant to a wholly-owned taxable corporation for 80 percent or 90 percent of all the net profits (before taxes and before the rent deduction). This arrangement enables the taxable corporation to escape nearly all of its income taxes because of the large "rent" deduction.

Proposed Change

The Code would be amended to provide that in any case in which an exempt organization owns more than 80 percent of a taxable subsidiary, interest, annuities, royalties and rents are to be treated as "unrelated business income" and subject to tax. The deductions connected with production of such income are allowed.

We support this proposed amendment of the Code.

SECTION 121 OF THE BILL--PROPOSED CODE SECTION 278

EXEMPT ORGANIZATIONS--LIMITATION ON DEDUCTIONS OF NONEXEMPT MEMBERSHIP ORGANIZATIONS

Present Law

Some courts have held that taxable membership organizations cannot create a "loss" by supplying their members services at less than cost. Other courts have held instead that such a "loss" is permissible. The expenses of providing such services at less than cost will offset from taxation additional income earned by the organization from investments or other activities.

Proposed Change

The House Bill provides that in the case of a taxable membership organization the deduction for expenses incurred in supplying services, facilities or goods to members is allowed only to the extent of the income from such members.

We support this proposed amendment of the Code.

SECTION 121 OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 513 EXEMPT ORGANIZATIONS - INCOME FROM ADVERTISING, ETC.

Present Law

Late in 1967 the Treasury promulgated regulations under which the income from advertising was treated as "unrelated business income" even though such advertising appeared, for example, in a periodical related to the educational or other exempt purpose of the organization.

The statutory language on which the regulations were based was sufficiently unclear so that substantial litigation could have resulted from these regulations.

Proposed Change

The House Bill provides that income from advertising (or a similar activity) is included in unrelated business income even though the advertising is carried on in connection with activities related to the exempt purpose.

AICPA Comments - General

The primary purpose of the tax on unrelated business income originally was to deal with the problem of unfair competition. The tax-free status of certain exempt organizations enabled them to use

their tax-free profits to expand operations, while their competitors could expand only with profits remaining after taxes. (See House Committee Report No. 2319, Eighty-first Congress, Second Session, accompanying the Revenue Act of 1950, which initially introduced the statutory predecessor of section 513 of the current Code. 1950-2 C.B. 429.)

While the 1950 House Report makes it clear that the intent of section 513 was to meet the problem of unfair competition, the statute itself is not in terms of unfair competition, but rather imposes a tax on the "unrelated business income" of certain organizations. Thus, Congress, in 1950, seems to have concluded that a business that is unrelated to the exempt purposes of an organization presents unfair competition. Conversely, a business that is related to the exempt purposes should not be regarded as presenting unfair competition. Nevertheless, the Treasury Department concluded otherwise when it adopted regulations under section 513 on December 11, 1967. The House Committee on Ways and Means agrees with that conclusion and with the purpose of the regulations. On page 50 of its report, (No. 91-413-Part 1) the Committee makes this statement: "In general, it (the Committee) is in agreement with the purpose of the regulations. Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage

by operating tax free unless the business contributes importantly to the exempt function. It has concluded that by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore it believes this income should be taxed." Accordingly, the House apparently agrees with the Treasury's Example (7) in Regulation Section 1.513-1(d)(4)(iv), which states that advertising income derived by an exempt organization is taxable under the following circumstances:

1. The organization is formed to advance the interests of a particular profession and draws its membership from members of that profession.
2. A monthly journal is published containing articles and other editorial material which contribute importantly to the accomplishment of the purposes for which exemption has been granted.
3. The journal's advertising promotes <u>only</u> products which are within the general area of professional interest of the organization's members.

The Treasury Department concedes that income from the sale of subscriptions to members and others, in accordance with the organization's exempt purposes, does not constitute gross income from an unrelated trade or business. However, the following fallacious conclusions are drawn with respect to the income from the limited type of advertising described in item 3, above:

"Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and its method. Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business...."

We believe that this interpretation and the conclusions of the House Ways and Means Committee, quoted above, suffer from inaccurate analysis on the following three counts:

1. Advertising that promotes <u>only</u> products or services of professional interest is <u>functionally</u> the same as editorial content that is concerned only with matters of the same professional interest (including, of course, articles that may discuss certain of these products or services). Since such editorial content is acknowledged to contribute importantly to the accomplishment of exempt purposes, the same

characterization can be attributed to such functionally related advertising. They are both related to the activities of the organization.

2. It is highly unrealistic to categorize an inter-dependent economic activity, such as the sale of space in a publication, as a trade or business.
3. Unfair competition, which was the problem intended to be solved by the Revenue Act of 1950, appears to be completely absent under the illustrative facts.

Specific Legislative Recommendations

We believe that Code section 512 and/or section 513 should be amended to incorporate the following concepts:

1. A "trade or business" should be defined along vertically integrated lines so that advertising activity, alone, cannot constitute a trade or business.
2. In order to avoid characterization as unrelated business income, all activities of such defined trade or businesses must be functionally related to the purposes for which an organization has been granted exemption.

Advertising income should not give rise to unrelated business income under the following circumstances:

1. The income is derived from magazines and other periodicals published by exempt organizations.

2. The publication's editorial matter and advertising are substantially related to purposes for which the organization has been granted exemption.

These criteria should considerably ease any anticipated enforcement burdens of the Internal Revenue Service since compliance with such standards could be easily observed by Service office personnel. For example, a centralized unit of the Service should be furnished with all exempt organization publications and could determine, through physical inspection, whether the necessary editorial and advertising policies are being maintained.

The <u>de minimis</u> rule provided by Code section 512(b)(12), allowing a $1,000 specific deduction, should be expanded in order to eliminate the tax where annual unrelated business income does not exceed $5,000. (See Technical Information Release No. 899, April 14, 1967, which announced the proposed regulations under sections 512-513 and indicated that the Internal Revenue Service would consider the appropriateness of a legislative recommendation to make the tax inapplicable where only "small" amounts of unrelated income are involved.)

In addition, where the unrelated business income tax is imposed, net operating loss carrybacks and carryovers should be allowed to the same extent as in the case of nonexempt entities conducting competitive operations. Compare the limitations set forth in Regulations Section 1.512(a)-1(d)(2)(ii) and (e), Example (2).

The following three examples are provided to illustrate the effect of the concepts which we propose be incorporated into the statute to deal with the tax treatment of advertising income derived by exempt organizations:

Examples of Effect of Legislative Recommendations

Example (1): No Unrelated Business Income Resulting from Related Editorial and Advertising Content

Z is an association exempt under section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession. Continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption.

Z publishes a monthly journal containing articles and other editorial material which contribute importantly to the accomplishment of purposes for which exemption is granted the organization.

The advertising in Z's journal promotes products which are within the specialized area of professional interest of Z's members. Since the advertisements contain information dealing with professional interest and development, their informational function is identical to the function of the editorial content. Accordingly, the publication of advertising designed and selected in this manner, pursuant to Z's advertising policies, is an educational activity of the kind contemplated by the exemption statute.

Therefore, Z's publication of advertising also contributes importantly to the accomplishment of its exempt purposes; and the

income which it derives from its publishing business, attributable to both literary and advertising activities, does not constitute gross income from an unrelated trade or business.

Example (2): Unrelated Business Income Resulting From Unrelated Literary Activity

Assume the same facts as in the preceding example, except that the editorial content of Z's journal is not exclusively devoted to professional matters since news and features covering domestic politics, foreign affairs and sports events are also published. This nonprofessional content is of a general nature, appealing to members of the particular profession involved as well as to the laity comprising the balance of our national population. Accordingly, the publication of this type of literary material is not designed nor selected to further Z's exempt purposes and would thus compete with other generalized magazines published by taxable organizations. Such editorial content is not an educational activity of the kind contemplated by the exemption statute.

Therefore, Z's publication of such literary material does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from its publishing business, attributable to both literary and advertising activities, constitutes gross income from an unrelated trade or business.

Example (3): Unrelated Business Income Resulting From Unrelated Advertising Activity

Assume the same facts as in Example (1), except that Z also derives income from the sale of space in its journal for

general consumer advertising, including advertisements of such products and services as soft drinks, automobiles, wearing apparel, home appliances and vacations arranged by travel agencies.

The publication of such advertisements does not contribute importantly to the accomplishment of any purpose for which exemption is granted and would thus compete with the advertising activity of magazines published by taxable organizations. Consequently, the income derived from Z's publishing business, attributable to both literary and advertising activities, constitutes gross income from an unrelated trade or business.

SECTION 201(a) OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 170(b)

CHARITABLE CONTRIBUTIONS -- 50 PERCENT CHARITABLE DEDUCTION LIMITATION

Present Law

Under present law, the charitable contributions deductions allowed individuals generally is limited to 30 percent of the taxpayer's adjusted gross income. In the case of gifts to certain private foundations, however, the deduction is limited to 20 percent of the taxpayer's adjusted gross income.

Proposed Change

The Bill increases the general limitation on the charitable contributions deduction for individual taxpayers from 30 percent of adjusted gross income to 50 percent of their contribution base. The 20-percent charitable contribution deduction limitation in the case of gifts to certain private foundations is not increased by the Bill. Also, contributions of appreciated property (which property, if sold, would be treated as giving rise to capital gain) is to be subject to the 30-percent limitation.

We support this proposed amendment to the Code.

SECTION 201(a) OF THE BILL--PROPOSED REPEAL OF CODE SECTION 170(b)(1)(C)

CHARITABLE CONTRIBUTIONS--REPEAL OF UNLIMITED CHARITABLE DEDUCTION

Present Law

An individual taxpayer is presently allowed an unlimited charitable deduction if in the current taxable year and in 8 of the preceding 10 taxable years the total of the taxpayer's charitable contributions plus income taxes (determined without regard to the tax on self-employment income) exceeds 90 percent of his taxable income (computed without regard to the charitable contributions deduction, personal exemptions and net operating loss carrybacks).

Proposed Change

The Bill would phase out the unlimited charitable contributions deduction over a 5-year period covering taxable years beginning in 1970 through 1974.

We support this proposed amendment to the Code.

SECTION 201(a) OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 170(b)

DISALLOWANCE OF CHARITABLE DEDUCTION FOR GIFT OF USE OF PROPERTY

Present Law

Presently a taxpayer may take a charitable deduction for the fair-rental value of property which he owns and gives to a charity to use for a specified time period. In addition he excludes from his income the income he would have received had the property been rented.

Proposed Change

H.R. 13270 provides that a charitable deduction is not to be allowed unless the taxpayer's entire interest in the property is donated. Therefore, no deduction will be allowed for the right to use property for a period of time. The taxpayer, however, will continue to be able to exclude from income the value of the right to use property so contributed.

We support this proposed amendment to the Code.

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SECTION 201(c) OF THE BILL--PROPOSED AMENDMENT OF CODE SECTION 170 AND ADDITION OF NEW SECTION 83

CHARITABLE CONTRIBUTIONS OF APPRECIATED PROPERTY

Present Law

A taxpayer who contributes to charity property which has appreciated in value generally is allowed a charitable contribution deduction for the fair market value of the property at the time of contribution (subject to certain technical recapture provisions), and no income tax is imposed on the appreciation in value of the property at the time of the gift.

Proposed Change

H.R. 13270 proposes to eliminate some of the present tax advantage of contributing appreciated property to certain private foundations by requiring the donor of such property to elect either to reduce his charitable contribution deduction to the amount of his cost or other basis for such property or to take a charitable contribution deduction based on the fair market value of the property but to include in his tax base the untaxed appreciation with respect to the property involved. The charitable donee's basis for the property would be the donor's adjusted basis (for purposes of determining gain increased by the amount of gain recognized by the donor with respect to the contribution).

Under the Bill, the same treatment would be applicable without regard to the type of charitable recipient, to:

1. All gifts of property if any portion of the gain on the property (had it been sold)

would have resulted in either ordinary income or short-term capital gain;

2. All charitable gifts of works of art, collections of papers and other forms of tangible personal property (fixtures which are intended to be severed from real property are to be treated for this purpose as tangible personal property); and
3. All charitable gifts of future interests in property.

AICPA Comments

Although we have not been able to reach a consensus on all of the Bill's proposals with reference to charitable contributions of appreciated property, we do agree contributions of such property should be treated in the same manner without regard to the type of charitable recipient.

SECTION 201(d) OF THE BILL--PROPOSED AMENDMENT OF CODE SECTION 1011

CHARITABLE CONTRIBUTIONS--BARGAIN SALES TO CHARITABLE ORGANIZATIONS

Present Law

If property is sold to a charity at a price below its fair market value, the proceeds of sale are considered to be a return of the cost and are not required to be allocated between the cost basis of the "sale" part of the transaction and the "gift" part. The seller is allowed a charitable contribution deduction for the difference between the fair market value of the property and the selling price.

Proposed Change

The Bill provides that the cost or other basis of the property is to be allocated between the portion of the property "sold" and the portion of the property "given" to the charity on the basis of the fair market value of each portion.

We support this proposed amendment of the Code.

SECTION 201(f) OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 642(c)

CHARITABLE CONTRIBUTIONS FOR ESTATES AND TRUSTS

Present Law

A nonexempt trust (or estate) is allowed a full deduction for any amount of its gross income which it pays or which it permanently sets aside for charitable purposes. There is no limitation on the amount of this deduction.

H.R. 13270 provides that an individual who establishes a trust to pay the income to a private person for a period of years with the remainder to go to charity is to be allowed a charitable deduction with respect to the charitable remainder interest only if the trust qualifies as a charitable remainder trust. It is also provided that no deduction is to be allowed for a charitable gift of an income interest in trust unless the individual making the gift is taxable on the trust income.

It would be inconsistent with these rules to continue to allow a trust a deduction for amounts set aside for charity. Such a deduction is unnecessary in the case of a charitable remainder trust since such a trust is to be tax exempt. In other cases, the allowance of a set-aside deduction would be inconsistent with the limitation to be placed on charitable gifts in trust.

Proposed Change

For the reasons discussed above, the Bill eliminates the so-called set-aside deduction presently allowed trusts (or estates). However, in computing its taxable income, a nonexempt trust will still be allowed to deduct any amount of its

gross income, without limitation, paid as a charitable contribution. In addition, to enable the trustee to act after he knows the income for the year precisely, the Bill allows a trustee to make a contribution in the next following taxable year and elect to treat such contribution as made during the taxable year. As under existing law, proper adjustment is to be made for charitable contributions paid out of capital gain income and the deduction is not to diminish the unrelated business income of the trust, if any. Furthermore, the nonexempt trust is to be subject to the same restrictions as a private foundation if it makes charitable contributions.

We support this proposed amendment to the Code.

SECTION 201(g) OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 673(b)

CHARITABLE CONTRIBUTIONS--REPEAL OF TWO-YEAR CHARITABLE TRUST RULE

Present Law

Under present law, an individual may establish a trust to pay the income from his property, which he transfers to the trust, to a charity for a period of at least 2 years, after which the property is to be returned to him. Although the individual does not receive a charitable contribution deduction in such a case, the income from the trust property is not taxed to the individual. This 2-year charitable trust rule is an exception to the general rule that the income of a trust is taxable to the person who establishes the trust where he has a reversionary interest in the trust which will or may be expected to take effect within 10 years.

The effect of the special 2-year charitable trust rule is to permit charitable contribution deductions in excess of the generally applicable percentage limitations of such deductions.

Proposed Change

In order to prevent circumvention of the generally applicable percentage limitations on the charitable contribution deduction, the House Bill would repeal the 2-year trust provision of Code section 673(b). Accordingly, an individual no longer will be able to exclude income from property placed in a trust (to pay the income to a charity for a period of at least 2 years) from his income. As a result, a person who establishes a trust

will be taxable on its income, whether or not the income beneficiary is a charity, where the individual has a reversionary interest which will or may be expected to take effect within 10 years from the time the income-producing property is transferred to the trust.

We support this proposed amendment to the Code.

SECTION 201(a) and (h) OF THE BILL-- PROPOSED AMENDMENTS TO CODE SECTIONS 170(b) and 2522(c)

CHARITABLE INCOME TRUSTS WITH NONCHARITABLE REMAINDER

Present Law

Under present law, a taxpayer who transfers property to a trust to pay the income to a charity for a period of years with the remainder to go to a noncharitable beneficiary, such as a friend or member of his family, is allowed a charitable contribution deduction for the present value of the income interest given to the charity. In addition, neither he nor the trust is taxed on the income earned by the trust.

A taxpayer receives a double tax benefit where he is allowed a charitable contribution deduction for the present value of an income interest in trust given to charity and also is not taxed on the income earned by the trust. In fact, this double benefit allows a taxpayer to increase his after-tax cash position by postponing a planned noncharitable gift.

Proposed Change

The Bill provides that a charitable contribution deduction is not to be allowed for an income interest given to charity in trust, unless the grantor is taxable on the income of the trust or unless all the interests in the trust are given to charity. The effect of this is to deny the double benefit of a deduction and exemption from taxation which is available under present law.

The Bill also provides that a charitable deduction will not be allowed for an income interest given to charity in trust unless either the interest is in the form of a guaranteed annuity or the trust instrument specifies that the charitable income beneficiary is to receive a fixed percentage annually of the fair market value of the trust property (as determined each year). The purpose of this rule is to assure that the amount received by the charity in fact bears a reasonable correlation to the amount of the charitable contribution deduction allowed the taxpayer.

If a taxpayer, who is allowed a charitable deduction under the above rules for an income interest transferred in trust to charity, subsequently ceases to be taxable on the trust income, he would receive a double tax benefit with respeet to the future trust income--he would not be taxed on that income but would have received a charitable deduction with respect to it. To prevent this result, the Bill, in effect, provides for the recapture of that part of the charitable contribution deduction previously received by the taxpayer with respect to the income of the trust which will go to the charity but on which he will not be taxed.

We support these proposed amendments to the Code.

SECTION 201(e), (h) and (i) OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 170(h), 2055(e), 2106(a) and 2522(c) AND PROPOSED CODE SECTION 664

CHARITABLE CONTRIBUTIONS--CHARITABLE REMAINDER TRUSTS

Present Law

An individual may now make a charitable contribution by transferring property to a trust and providing that the trust income be paid to designated private persons for a period of time with the remainder to go to a charity. The amount of the deduction is based upon the present value of the remainder interest at the time of the gift.

Under the present rules it is possible for a taxpayer to receive a deduction for a contribution of a remainder interest to a charity which may be greater than the amount the charity ultimately receives. This is possible because the trust assets may be invested in a manner which maximizes income at the expense of capital.

Proposed Change

To prevent the above situation the Bill provides that no deduction will be allowed for gifts of a remainder interest unless the trust specifies that the noncharitable income beneficiary is to receive either a stated annual dollar amount or a fixed percentage of the value of the trust assets.

We support these proposed amendments to the Code.

SECTION 211 OF THE BILL--PROPOSED CODE SECTION 1251

FARM LOSSES

Present Law

Under present law, income or losses from farming may be computed under more liberal accounting rules than those generally applicable to other types of businesses. A cash method of accounting under which costs are deducted currently may be used, rather than an inventory and accrual method under which the deduction of costs would be postponed. In addition, a taxpayer in the business of farming may deduct expenditures for developing business assets (such as raising a breeding herd or developing a fruit orchard) which other taxpayers generally have to capitalize. Furthermore, capital gain treatment often is available on the sale of farm assets.

The combination of current deductions of farm expenses of a capital nature from ordinary income with future capital gain treatment on the sale of farm assets may produce significant tax savings.

Proposed Change

The Bill generally provides that gain on the sale of certain farm property is to be treated as ordinary income to the extent of the taxpayer's previous farm losses. For this purpose, a taxpayer must maintain an excess deductions account to record his farm losses. In the case of individuals, farm losses must be added to the excess deductions account only if the taxpayer has more than $50,000 of nonfarm income for the year and, in addition, only to the extent his farm loss for the year exceeds

$25,000. The amount in a taxpayer's excess deductions account would be reduced by the amount of farm income in subsequent years.

The amount of farm losses recaptured on a sale of farm land would be limited to the deductions for the taxable year and the four previous years with respect to the land for soil and water conservation expenditures and for land clearing expenditures.

To the extent gain on the sale of farm property is treated under these rules as ordinary income, this would reduce the amount in the taxpayer's excess deductions account.

The recapture rules provided by the Bill would not apply if the taxpayer elected to follow generally applicable business accounting methods (i.e., if he used inventories and capitalized capital expenditures).

AICPA Comments

We agree with the intended purpose of the proposed legislation which is to curb abuses of capital gain provisions in the farming segment of the economy.

Section 211 of the Bill seeks to solve this problem by denying capital gain benefits in the case of the disposition of farm property unless the taxpayer (1) accounts for inventories, and (2) capitalizes all expenditures properly chargeable to a capital account. The de minimis exception (later commented on) appears to be reasonable to limit the application of Section 211 to taxpayers who could otherwise abuse capital gain benefits.

On the other hand, we believe that the language of Section 211 is so sweeping that it will affect more taxpayers than intended. Section 211 applies to all taxpayers who, with respect to any taxable year, (1) incur a farm net loss, <u>or</u> (2) have a balance in the excess deductions account at the close of the taxable year. Addition to the excess deductions account for a current year's farm loss is not required if (1) nonfarm adjusted gross income is $50,000 or less, and (2) the farm net loss is $25,000 or less. However, it appears that the $50,000/$25,000 de minimis exceptions do not apply to excuse application of Section 211 in the face of a current year's loss, no matter how small (proposed Code section 1251(a)(1)). Should this be the case, Section 211 would apply to all taxpayers incurring a current farm loss, with the result that a great many farmers would be faced with loss of capital gain benefits if they did not elect to adopt certain accounting methods. To remedy this apparent defect, we recommend that the Bill be clarified so that there is no doubt that the $50,000/$25,000 de minimis exceptions apply also in the case of farm net losses for the current taxable year.

In order not to discourage taxpayers from changing to the accounting methods described in proposed Code section 1251 (b)(4)(A), it is suggested that section 1251(b)(4)(C) provide that additions to taxable income resulting from the change could be spread over a 10-year period, at the election of the taxpayer. This type of provision has been helpful in Internal Revenue Service administration of other changes in accounting methods and practices, and should be advantageous to both taxpayers and the Government in this connection.

SECTION 213 OF THE BILL -- PROPOSED AMENDMENT TO CODE SECTION 270

HOBBY LOSSES

Present Law

Present law contains a so-called hobby loss provision which limits to $50,000 per year the amount of losses from a "business" carried on by an individual that he can use to offset his other income. This limitation only applies, however, if the losses from the business exceed $50,000 a year for at least five consecutive years. Moreover, certain specially treated deductions are disregarded in computing the size of the loss for this purpose.

Proposed Change

The Bill replaces the present hobby loss provision with a rule which provides that items attributable to an activity shall be allowed only to the extent of the gross income from such activity unless such activity is carried on with a reasonable expectation of realizing a profit. If the deductions attributable to an activity exceed the gross income from such activity by $25,000 or more for any 3 of 5 consecutive years ending with the taxable year, then unless the taxpayer establishes to the contrary, the activity shall be deemed to have been carried on without a reasonable expectation of realizing a profit.

AICPA Comments

We agree with the intended purpose of the proposals which are aimed at making the application of Code section 270 (as amended) more effective.

It does appear, however, that the proposed provisions should be modified to the following extent:

1. The $25,000 excess of deduction over gross income should be changed to $50,000. (section 270(b)).
2. Wherever it appears throughout the section, the term "activity" should be changed to "trade or business."
3. The application of this section should be limited to individual taxpayers.

It is our belief that the disallowance of losses using the $25,000 limitation is too harsh considering that the entire loss would be disallowed. Moreover, in these times of inflation, the $25,000 limitation does not seem realistic where new business ventures are undertaken. Small taxpayers often lose more than $25,000 in three out of five years (particularly the early years of an undertaking).

The statutory word "activity" is bound to cause much controversy in the administration of the law. This word is not defined in the Bill; in fact, it would be difficult to define. An activity can embrace an entire trade or business, it can be a functional part of a business, or it can be a segment of a taxpayer's financial activities. For example, a taxpayer operating a manufacturing enterprise may have several plants, warehouses and sales outlets. Is each an activity? Where a taxpayer operates two businesses such as a drug store and an automobile agency, may

each be an activity? Is the purchasing arm of a retail establishment an activity? Where a taxpayer operates a crop farm in conjunction with a livestock farm, is each an activity or must both be combined as one activity? Where individual taxpayers enter into financial transactions such as investments in securities, acquiring interests in real estate, etc., are each of these "an activity" for the purposes of the proposed legislation?

In order to avoid unnecessary uncertainty and confusion and to deal in an equitable manner with what is probably intended, we suggest that the term "trade or business" be substituted for "activity." This term already has an established meaning under present law and under numerous court decisions. It embraces a set of activities that make up a "whole concept" as distinguished from dealing with possibly meaningless fragments of operations which could cause severe difficulties in tax accounting, allocations and administration.

It seems from the wording of the proposed amendment that it would apply to all taxpayers. We have seen no suggestion in the Reports of the Committee on Ways and Means nor do we know of any abuses by corporations, trusts, estates and other taxpayers in the area for which correction is sought. Accordingly, it is urged that this proposed amendment be limited to individual taxpayers.

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SECTION 221 OF THE BILL--PROPOSED AMENDMENT TO CODE SECTIONS 163 and 1202

LIMITATION ON DEDUCTION OF INTEREST

Present Law

Under present law, individual taxpayers are allowed an itemized deduction, without limitation, for all interest paid or accrued during the taxable year.

Proposed Change

The Bill would limit the deduction allowed individuals and other noncorporate taxpayers for interest on funds borrowed for investment purposes. The limitation would not apply to interest incurred on funds borrowed for other purposes, such as home mortgages, installment purchases, consumer goods, personal or student loans, or in connection with a trade or business. Under the limitation, the taxpayer's deduction for investment interest would be limited to the amount of his net investment income, plus an amount equal to the amount by which his net long-term capital gain exceeds his net short-term capital loss, plus $25,000 ($12,500 in the case of a separate return by a married individual).

Interest for which a deduction was disallowed in a year as a result of the limitation could be carried over to subsequent years and used to offset net investment income (including capital gains) arising in the later years to the extent allowable under the limitation in such a year.

In the case of partnerships, the limitation would apply at both the partnership and the partner levels.

AICPA Comments

We do not agree with this proposed amendment of the Code. It has long been an established general principle of economics, accounting and taxation that expenses incident to the production of income are deductible from such income. This legislative proposal in a sense represents an artificial and arbitrary mutation of this principle which would tend to discourage the assumption of risk and the investment of capital -- both of which have been important factors in the growth and development of our economic system. Furthermore, it would constitute an inconsistent exception to the cash receipts and disbursements method of accounting under which expenses are deducted when they are paid and income is taxed when it is received.

If, however, this proposed amendment of the Code is enacted in basically its present form, it is suggested that the limitation be made applicable at both the corporate and the shareholder level in the case of electing small business corporations as defined in Code section 1371(b).

SECTION 231 OF THE BILL--PROPOSED CODE SECTION 82 AND PROPOSED AMENDMENT TO CODE SECTION 217

MOVING EXPENSES

Present Law

A deduction from gross income is allowed for certain moving expenses related to job-relocation or moving to a first job.

Two conditions must be satisfied for a deduction to be available. First the taxpayer's new principal place of work must be located at least 20 miles farther from his former residence than his former principal place of work (or, if the taxpayer had no former place of work, then at least 20 miles from his former residence). Second, the taxpayer must be employed full time during at least 39 weeks of the 52 weeks immediately following his arrival at the new principal place of work.

Job-related moves often entail considerable expense in addition to the direct costs of moving the taxpayer, his family and his personal effects to the new job location.

Moreover, the 20-mile test allows a taxpayer a moving expense deduction even where the move may merely be from one suburb of a locality to another, and the 39-week test denies the deduction where a taxpayer is prevented from satisfying the test by circumstances beyond his control.

Proposed Change

The Bill extends the present moving expense deduction to also cover three additional types of job-related moving expenses:

1. Travel, meals and lodging expenses for pre-move house hunting trips;
2. Expenses for meals and lodging in the general location of the new job location for any period of up to 30 consecutive days after obtaining employment; and
3. Various reasonable expenses incident to the sale of a residence or the settlement of a lease at the old job location, or to the purchase of a residence or the acquisition of a lease at the new job location.

A limitation of $2,500 is placed on the deduction allowed for these three additional categories of moving expenses. In addition, expenses for the house- hunting trips and temporary living expenses may not account for more than $1,000 of the $2,500.

The Bill also increases the 20-mile test to a 50-mile test, and provides that the 39-week test is to be waived if the taxpayer is unable to satisfy it due to circumstances beyond his control. Finally, the Bill requires that reimbursements for moving expenses must be included in gross income.

AICPA Comments--General

The Bill provides a maximum deduction of $2,500 for three additional types of job-related expenses: (1) travel, meals and lodging expenses in connection with house-hunting trips; (2) expenses for meals and lodging in the new job location area for any period of up to 30 consecutive days after obtaining the new job; and (3) expenses concerning the sale of a residence or settlement of a lease at the old job location or comparable expenses at the new job location. The deduction for the first two types of expenses may not exceed $1,000 of the maximum $2,500.

We do not believe these amounts are realistic. Many persons transferred own a house which has a market value of $30,000 or more. The average real estate agent's fee for the sale of such a house is 6 percent, or $1,800. In such a situation the allowable deduction for the first two types of expenses would be limited to $700. Thus, a taxpayer transferred to an area of 100 miles from his present location would probably not be out-of-pocket; however, a taxpayer transferred 1,000 miles would probably be out-of-pocket because of the additional transportation costs for himself and his family. We recommend that there be no limitation on the amount allowed as a deduction for these three types of expenses or, in the alternative, that the $1,000 be increased to $2,000 and the $2,500 be increased to $5,000.

Code section 217, as amended, refers to a deduction by a taxpayer as an employee. We recommend that this section also

authorize such a deduction by a self-employed taxpayer or by a partner of a partnership. There is no reason why such taxpayers should not be entitled to the same benefits as an employee.

The proposal requires as a condition to allowance that the new place of work be 50 miles further from the old residence than the place of former employment. The requirement is excessive. An employee formerly commuting 20 miles to his old employment in some cases could not qualify for the deduction unless the new employment was 70 miles from his former residence. This is not realistic even in our largest metropolitan areas. The 20-mile rule should be retained, although an alternative provision of 20 miles or 50 percent further, whichever is greater, might provide some restriction on the supposed favored treatment of a person originally commuting a substantial distance.

Section 231(d) of the Bill should be changed to make the effective date applicable to taxable years beginning on or after January 1, 1964, and should permit the filing of claims for refund within one year from the date the Bill becomes law for those taxable years for which the three-year statute of limitations has expired. It is patently unfair to taxpayers who have moved in prior years and suffered a cash loss not to permit them to file claims for refund.

SECTION 301 OF THE BILL--PROPOSED CODE SECTION 84

LIMIT ON TAX PREFERENCES

Present Law

Under present law, there is no limit on how large a part of his income an individual may exclude from tax as a result of the receipt of various kinds of tax-exempt income or special deductions.

Proposed Change

The Bill would impose a 50 percent ceiling on the amount of a taxpayer's total income (adjusted gross income plus tax preference items) which can be excluded from tax. This limitation would not be applicable if an individual's total tax preferences for the year did not exceed $10,000, or $5,000 for a married person filing a separate return.

AICPA Comments

The provisions of the Bill placing a limit on tax preferences would impose a tax by indirect means on amounts which presently are fully or partially tax exempt. We agree that public confidence in our self-assessment system is undermined by the ability of individuals to realize large amounts of disposable income with little, if any, payment of tax. However, we recommend that the tax preference items be dealt with through direct legislation. If this is not practicable then we would support the provisions of the Bill -- with one modification. The tax preference item regarding the excess

of accelerated depreciation over straight line depreciation should likewise provide for a reduction when straight line depreciation exceeds accelerated depreciation.

SECTION 302 OF THE BILL--PROPOSED CODE SECTION 277

ALLOCATION OF DEDUCTIONS

Present Law

Under present law an individual is permitted to charge his personal income tax deductions entirely against his taxable income without charging any part of these deductions to his tax-free income. As a result, taxpayers with substantial tax preference amounts and personal deductions can eliminate much or all of their tax liability on substantial amounts of otherwise taxable income.

Proposed Change

To prevent individuals with tax preference amounts from reducing their tax liabilities on their taxable incomes by charging all their personal deductions to their taxable incomes, the Bill provides that individuals (and estates and trusts) must allocate most of their itemized personal deductions proportionately between their taxable income (adjusted gross income less nonallocable expenses) and their tax preference amounts. Only the part of these personal deductions which is allocated to taxable income is to be allowed as a tax deduction and the personal deductions allocated to the tax preference amounts are to be disallowed. Tax preference amounts are taken into account only to the extent they exceed $10,000 ($5,000 for a married person filing a separate return).

We support this section of the Bill.

SECTION 311 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 1301-1305

INCOME AVERAGING

Present Law

Income averaging permits a taxpayer to mitigate the effect of progressive tax rates on sharp increases in income. His taxable income in excess of 133-1/3 percent of his average taxable income for the prior 4 years generally can be averaged and taxed at lower rates than would otherwise apply. Certain types of income such as net long-term capital gains, wagering income, and income from gifts are not eligible for averaging.

The exclusion of certain types of income from income eligible for averaging complicates the tax return and makes it difficult for taxpayers to determine easily whether or not they would benefit from averaging. In addition, taxpayers with fluctuating income from these sources may pay higher taxes than taxpayers with constant income from the same sources or fluctuating income from different sources. Finally, the 133-1/3 percent requirement denies the benefit of averaging to taxpayers with a substantial increase in income and reduces the benefits of averaging for those who are eligible.

Proposed Change

The Bill extends income averaging to net long-term capital gains, income from wagering and income from gifts. It also lowers the percentage by which an individual's income must increase for averaging to be available from 33-1/3 percent to 20 percent.

AICPA Comments

We support this provision of the Bill but take exception to the proposed effective date of taxable years beginning after December 31, 1969. We note that the provisions of the Bill dealing with the repeal of the alternative tax on capital gains for individuals (Bill section 511) are to be effective with respect to sales and dispositions occurringafter July 25, 1969. The effective dates of these two provisions coupled with the 10 percent tax surcharge now in effect subjects long-term capital gain realized by individuals in the brief period from July 26 to December 31 to a severe and inequitable tax penalty. We believe equity dictates that the effective dates for eliminating the alternative capital gains tax and introducing the new averaging provisions be the same.

NOTE: Please refer to our comments in the Summary regarding the effective dates of capital gains and losses.

SECTION 321 OF THE BILL--PROPOSED CODE SECTION 85 AND PROPOSED AMENDMENTS TO CODE SECTIONS 402(b) AND 403

RESTRICTED PROPERTY

Present Law

At present the treatment of restricted property is governed by Treasury regulations which provide for no tax when the employee receives the restricted stock. When the restrictions lapse, the value of the stock at the time of transfer to the employee (determined without restrictions) is treated as compensation provided it has increased in value. If the value decreases then the lower value is considered the compensation.

Proposed Change

Section 321 of the Bill provides that a person who receives a beneficial interest in property by reason of services performed is to be taxed with respect to the property at the time it is received if he can transfer the property and if it is not subject to substantial risk of forfeiture. If there is a substantial risk of forfeiture a tax is imposed when the risk lapses. The tax will be on the amount by which the fair market value of the property exceeds the amount the employee paid for it.

AICPA Comments

We support this provision on condition that any legislation finally approved continues to provide for the 50 percent maximum rate on earned taxable income. This provision, coupled with the capital gain provisions in the Bill, reflects

a recognition of equality of tax treatment between earned income and capital gain income. We believe that these provisions, taken together will continue to provide incentive for those who have contributed much to our economic progress and will also lessen the search for transactions motivated by tax avoidance.

SECTIONS 341 AND 342 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 665-669 and 677

ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

Present Law

If a grantor creates a trust under which the trustee is either required or is given discretion to accumulate the income for the benefit of designated beneficiaries, then to the extent the income is accumulated, it is taxed at individual rates to the trust.

When the trust distributes accumulated income to the beneficiaries, in some cases they are taxed on the distributions under a so-called throwback rule. The throwback rule treats the income for tax purposes as if it had been received by the beneficiaries in the years in which it was received by the trust. The beneficiary recomputes his tax for these back years, adding the trust income to it and taking credit for the tax which had been paid by the trust on that income, and pays the additional tax due in the current year.

In addition to the limitation of its application to the 5 years preceding the year of distribution, the throwback rule does not apply to several types of distributions.

The progressive tax rate structure for individuals may be avoided when a grantor creates trusts which accumulate income taxed at low rates, and the income in turn is distributed at a future date. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary.

Proposed Change

H.R. 13270 provides that beneficiaries are to be taxed on distributions received from accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiaries currently as earned, instead of being accumulated in the trust.. The Bill, in effect, eliminates the 5-year limitation and all exceptions to the throwback rule, and provides an unlimited throwback rule with respect to accumulation distributions. However, only distributions of income accumulated by a trust (other than a foreign trust created by a U.S. person) in years beginning after April 22, 1964 are to be subject to the throwback rule.

In the case of these accumulation trusts, all of their accumulated income, other than income distributable currently, is to be taxed to the beneficiaries upon its distribution to them. The amounts distributed are to be treated as if they had been distributed in the preceding years in which income was accumulated but are includible in income of the beneficiaries for the current year.

The Bill also provides that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

AICPA Comments

We agree with these provisions of the Bill in principle. However, it is wholly inconsistent for the equitable administration of the income tax law to provide effective dates for implementation of proposed restrictive changes which are retroactive in effect and impact. Thus, we disagree with the proposal that the changes embodied in Bill section 341 should be reflected for distributions made subsequent to April 23, 1969 based on amounts accumulated since April 23, 1964. Many trusts were set up on the basis of the exception to throwback available in section 665(b) of the Code (prior to the proposed changes). These include so-called minors' trusts which terminate at age 21 and payment of amounts as final distributions by trusts which are made more than nine years after the date of last transfer to such trust. In many cases by the terms of the trust instrument, distributions could not take place prior to April 23, 1969 and in many other situations taxpayers could not be on notice that action had to have taken place prior to the proposed effective date in order to avoid adverse tax impact.

Therefore, it is proposed that the changes set forth in section 341 of the Bill be applicable only to those trusts established or additions made to existing trusts after April 23, 1969 with respect to eliminating the exceptions available under Code section 665(b). Concomitantly, it is suggested and recommended that for those accumulation trusts which cannot qualify under these exceptions, the effective date with respect to full or maximum throwback apply only to accumulations in fiscal years ending after April 23, 1969.

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SECTION 401 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 46, 179, 821, 823, 1561-1563 AND PROPOSED CODE SECTION 1564

MULTIPLE CORPORATIONS

Present Law

Under present law, corporations generally are taxed at the rate of 22 percent on the first $25,000 of taxable income and at 48 percent of taxable income in excess of $25,000. The lower tax rate on the first $25,000 of taxable income is commonly referred to as the surtax exemption.

Present law limits to some extent the ability of a taxpayer to split his business enterprise into a number of corporations so as to obtain multiple surtax exemptions by providing that a "controlled group" of corporations is limited to one surtax exemption. Instead of claiming one surtax exemption for the group of corporations, however, a controlled group may elect for each member to take a surtax exemption if each of the corporations pays an additional 6 percent tax on the first $25,000 of its taxable income.

Although the surtax exemption was designed to help small businesses, large organizations have been able to obtain substantial benefits from the exemption by dividing the organization's income among a number of related corporations.

In addition to the surtax exemption, there are other provisions of present law designed to aid small businesses. These other provisions are: (1) the provision which allows a corporation to accumulate $100,000 of earnings without being subject to the penalty tax on earnings unreasonably accumulated to avoid the dividend tax on shareholders; (2) the life insurance company small business deduction of 10 percent of the company's

net investment income (this deduction is limited to $25,000 per year); (3) the exception to the general 50 percent limitation on the investment credit which allows 100 percent of tax liability up to $25,000 to be taken into account, and the investment credit provision which allows up to $50,000 of used (as distinct from new) equipment to qualify for the credit; (4) the provision which allows an additional first year depreciation allowance equal to 20 percent of the cost of the property (limited to $10,000 per year); (5) the provision which grants mutual insurance companies (other than life and marine) benefits similar to the surtax exemption; and (6) the provision which exempts mutual companies (other than life or marine) from tax if their investment income does not exceed $150,000.

Proposed Change

H.R. 13270 provides that a controlled group of corporations is only to be allowed one surtax exemption and in addition is not to be allowed to receive multiple benefits under other provisions of the law designed to aid small businesses. Generally, the limitation provided by the Bill is to be phased in over an 8-year period and is to be fully effective for 1976 and later years.

A controlled group of corporations is limited to one $25,000 surtax exemption and one $100,000 accumulated earnings credit after an 8-year transition period. This is accomplished by gradually reducing the amount of the special provisions in excess of one which is presently being claimed by a controlled group over the years 1969 to 1975 until these excess special provisions are reduced to zero for 1976 and later years.

The limitation on multiple benefits from the investment credit and first year additional depreciation, becomes fully effective with taxable years ending on or after December 31, 1969. To ease the transition, controlled corporations are allowed to increase the dividend received deduction from 85 percent to 100 percent at a rate of 2 percent per year.

Under the present consolidated return regulations, preconsolidation losses for a corporation in a group claiming multiple surtax exemptions may be carried over after consolidation only against the income of the corporation which sustained the losses. The Bill modifies these present regulations so as to permit net operating losses for a taxable year ending on or after December 31, 1969, to be taken as a deduction against the income of other members of such group in the same proportion as the additional surtax exemptions of such group.

The Bill also broadens the definition of a controlled group of corporations.

We support these proposed amendments to the Code.

SECTION 411 OF THE BILL-- PROPOSED CODE SECTION 279

CORPORATE MERGERS— DISALLOWANCE OF INTEREST DEDUCTION IN CERTAIN CASES

Present Law

Under present law a corporation is allowed to deduct interest paid by it on its debt but is not allowed a deduction for dividends paid on its stock or equity.

It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Although this problem is a long-standing one in the tax laws, it has become of increasing significance in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisition purposes.

There are a number of factors which make the use of debt for corporate acquisition purposes desirable, including the fact that the acquiring company may deduct the interest on the debt but cannot deduct dividends on stock.

Proposed Change

In general, the Bill disallows a deduction for interest on bonds issued in connection with the acquisition of a corporation where the bonds have specified characteristics which make them more closely akin to equity.

The disallowance rule of the Bill only applies to bonds or debentures issued by a corporation to acquire stock in another corporation or to acquire at least two-thirds of the total value of the assets of another corporation. Moreover, the disallowance rule only applies

to bonds or debentures which have all of the following characteristics; (1) they are subordinated to the corporation's trade creditors; (2) they are convertible into stock; and (3) they are issued by a corporation with a ratio of debt to equity which is greater than two to one or with an annual interest expense on its indebtedness which is not covered at least three times over by its projected earnings.

An exception to the treatment provided by the Bill is allowed for up to $5 million a year of interest on obligations which meet the prescribed test.

This provision of the Bill also does not apply to debt issued in tax-free acquisitions of stock of newly formed or existing subsidiaries, or in connection with acquisitions of foreign corporations if substantially all of the income of the foreign corporation is from foreign sources.

AICPA Comments

We disagree with section 411 of the Bill, which would add new section 279 to the Code. It is our view that any restrictions on the "tide of conglomerate mergers" should be imposed outside the tax law. In any event, we feel that the criteria contained in proposed Code sections 279(b) and (c) are arbitrary and of doubtful validity. Furthermore, the $5 million amount contained in proposed section 279(a) is discriminatory. Other difficulties will involve tracing problems and the question of what constitutes a "plan" of acquisition. Finally, the section will adversely affect persons who for valid business reasons may desire to sell their businesses in that they may

be unable to realize a proper price because of the depressing effect of proposed section 279.

SECTION 412 OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 453(b)

CORPORATE MERGERS— LIMITATION ON INSTALLMENT SALES PROVISION

Present Law

Under present law, a taxpayer may elect the installment method of reporting a gain on a sale of real property, or a casual sale of personal property where the price is in excess of $1,000. The installment method, however, is available only if the payments received by the seller in the year of sale (not counting debt obligations of the purchaser) do not exceed 30 percent of the sales price.

The Internal Revenue Service has not ruled as to whether the installment method of reporting gain is available where the seller receives debentures. The use of the installment method of reporting gain where debentures are received by a seller of property may result in long-term tax deferral. Present law does not specify the number of installments which are required if a transaction is to be eligible for the installment method of reporting. In other words, it is not clear whether the installment method may be used when there is only one or a limited number of payments which may be deferred for a long time.

Proposed Change

The Bill places two limitations on the use of the installment method of reporting gain on sales of real property and casual sales of personal property.

First, bonds with interest coupons attached, in registered form, or which are readily tradable, in effect are to be considered payments in the year of sale for purposes of the rule which denies

the installment method where more than 30 percent of the sales price is received in that year.

The second limitation is contained in proposed Code section 453(b)(3). It would deny the use of the installment method unless the payment of the loan principal, or the payment of the loan principal and the interest together, are spread relatively evenly over the installment period. This requirement would be satisfied if either payments are made at least once every two years in relatively even or declining amounts over the installment period, or at least 5 percent of the loan principal is to be paid by the end of the first quarter of the installment period, 15 percent is to be paid by the end of the second quarter, and 40 percent is to be paid by the end of the third quarter.

AICPA Comments

We disagree with section 412 of the Bill to the extent that it would add proposed section 453(b)(3) to the Code. It is our concern that proposed section 453(b)(3) will disqualify from installment sale treatment transactions which presently have good business purpose. It would add more uncertainties to an already difficult area. Furthermore, problems presented by extensions, calls or other modifications are not provided for. It is our view that proposed section 453(b)(4), with which we concur, is adequate to cover present abuses of the installment method.

SECTION 413 OF THE BILL-- PROPOSED AMENDMENT TO CODE SECTION 1232

CORPORATE MERGER— ORIGINAL ISSUE DISCOUNT

Present Law

Under present law, original issue discount arises when a corporation issues a bond for a price less than its face amount. The owner of the bond is not taxed on the original issue discount until the bond is redeemed or until he sells it, whichever occurs earlier.

The corporation issuing the bond, on the other hand, is allowed to deduct the original issue discount over the life of the bond.

This results in a nonparallel treatment of original issue discount between the issuing corporation and the bondholder. The corporation deducts a part of the discount each year. On the other hand, the bondholder is not required to report any of the discount as income until he disposes of the bond.

Proposed Change

The Bill generally provides that the bondholder and the issuing corporation are to be treated consistently with respect to original issue discount. Thus, the Bill generally requires a bondholder to include the original issue discount in income ratably over the life of the bond. This rule applies to the original bondholder as well as to subsequent bondholders.

Corporations issuing bonds in registered form would be required to furnish the bondholder and the Government with an annual

information return regarding the amount of original issue discount to be included in income for the year.

AICPA Comments

We do not agree with section 413 of the Bill. We feel that the proposed changes violate the well-established rules of the cash method of accounting and further that they will add to complexity and information reporting difficulties far out of proportion to the problem which section 413 is designed to solve.

We should like to recommend an alternative solution to the problem. We suggest that Code section 1221 be amended to exclude from the definition of a capital asset all corporate nonconvertible debt (sometimes referred to as "straight" debt). Such a provision would make all gains and losses on sales of nonconvertible corporate debt ordinary income or ordinary deductions, respectively. Nonconvertible corporate debt is acquired by an investor for the principal purpose of realizing a yield on the money invested. It appears that the market value of nonconvertible corporate debt obligations fluctuates in large measure with reference to prevailing interest yields. Accordingly, it seems reasonable to tax as ordinary income or allow as ordinary deductions gains or losses on disposition of the obligations which are primarily mere adjustments of yields.

We are cognizant of the fact that changes in market value of nonconvertible corporate debt can also be attributable to a change in the credit rating of the issuer, and it is true that it might be appropriate to reflect this element as capital gain or loss.

However, we feel on balance that the treatment of nonconvertible corporate debt as a noncapital asset will eliminate or reduce the importance of many complexities, including those resulting from Code sections 171 and 1232.

SECTION 414 OF THE BILL--PROPOSED CODE SECTION 249

CORPORATE MERGERS--CONVERTIBLE INDEBTEDNESS REPURCHASE PREMIUMS

Present Law

Under present law, there is a question as to whether a corporation which repurchases its convertible indebtedness at a premium may deduct the entire difference between the stated redemption price at maturity and the actual repurchase price. The Internal Revenue Service takes the position that the deduction is limited to an amount which represents a true interest expense (i.e., the cost of borrowing) and does not include the amount of the premium attributable to the conversion feature. This part of the repurchase is viewed by the Internal Revenue Service as a capital transaction analogous to a corporation's repurchase of its own stock for which no deduction is allowable. There are however, two court cases which hold to the contrary in that they allowed the deduction of the entire premium. Other court cases have been filed by taxpayers to test the validity of the Service's position on this matter.

Proposed Change

In order to clarify the treatment of premiums paid on the repurchase by a corporation of its indebtedness which is convertible into its own stock (or the stock of a controlling or controlled corporation), the Bill provides that the amount of the premium which may be deducted is to be limited to an amount not in excess of a normal call premium for nonconvertible

corporate indebtedness. The amount of the premium paid by the corporation upon the repurchase is to be the excess of the amount paid over the issue price of the indebtedness (plus any amount of discount previously deducted and minus any amount of premium previously reported as income).

It is further provided by the Bill that a larger deduction may be allowed with respect to the premium where the corporation can demonstrate to the satisfaction of the Secretary or his delegate that the amount of the premium in excess of that otherwise allowed as a deduction is related to the cost of borrowing and is not attributable to the conversion feature of the indebtedness. This exception is designed to allow for changes in the interest rates and to permit market and credit conditions to be taken into account.

We support this proposed amendment to the Code.

SECTION 421 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 301 and 305

TAX TREATMENT OF STOCK DIVIDENDS

Present Law

In its simplest form, a stock dividend is commonly thought of as a mere readjustment of the stockholder's interest, and not as income. For example, if a corporation with only common stock outstanding issues more common stock as a dividend, no basic change is made in the position of the corporation and its stockholders. No corporate assets are paid out, and the distribution merely gives each stockholder more pieces of paper to represent the same interest in the corporation.

On the other hand, stock dividends may also be used in a way that alters the interests of the stockholders. For example, if a corporation with only common stock outstanding declares a dividend payable, at the election of each stockholder, either in additional common stock or in cash, the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. His interest in the corporation is increased relative to the interests of stockholders who took dividends in cash. Under present law, the recipient of a stock dividend under these conditions is taxed as if he had received cash.

Sometimes, by means of such devices as convertible securities with changing conversion ratios, or systematic redemptions, the effect of an election to receive cash or stock can be achieved without any actual distribution of stock dividends, and therefore without any current tax to the stockholders whose interests in the corporation are increased.

Proposed Change

The Bill provides that a stock dividend is to be taxable if one group of shareholders receives a distribution in cash and there is an increase in the proportionate interest of other shareholders in the corporation. In addition, the distribution of convertible preferred stock is to be taxable unless it does not result in such a disproportionate distribution.

The Bill also deals with the related problem of stock dividends on preferred stock. Since preferred stock characteristically pays specified cash dividends, all stock dividends on preferred stock (except antidilution distributions on convertible preferred stock) are a substitute for cash dividends, and all stock distributions on preferred stock (except for antidilution purposes) are taxable under the Bill.

We support this section of the Bill.

SECTION 501(b) OF THE BILL--PROPOSED CODE SECTION 636

NATURAL RESOURCES - MINERAL PRODUCTION PAYMENTS

Present Law

A mineral production payment is a right to a specified share of the production from a mineral property (or a sum of money in place of the production) when that production occurs. Depending on how a production payment is created, it may be classified as a carved-out production payment, or retained production payment which may then be used in a so-called "ABC" transaction.

The use of carved-out production payments can be used to circumvent the limitations on the depletion deduction and the foreign tax credit and to distort the benefits that the net operating loss provisions were designed to provide. In addition, in ABC transactions, taxpayers are able to pay off what is essentially a purchase money mortgage with before-tax dollars rather than after-tax dollars.

Proposed Change

The Bill provides in general that carved-out payments and retained payments (including ABC transactions) are to be treated as a loan by the owner of the production payment to the owner of the mineral property.

In the case of a carved-out production payment, the Bill provides the payment is to be treated as a mortgage loan on the mineral property (rather than as an economic interest in the property).

This treatment is not to apply to a production payment carved out for exploration or development of a mineral property if,

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under existing law, gross income is not realized by the person creating the production payment.

In the case of retained production payments (that is, the sale of mineral property subject to a production payment), the Bill provides that the production payment is to be treated as a purchase money mortgage loan (rather than as an economic interest in the mineral property).

AICPA Comments

We recommend that an exception be made to the treatment provided for in section 501(b) of the Bill for production payments used to equalize the investment of participants in a unitization. Producing properties are often unitized in the interest of conservation of natural resources and more efficient production. Some of the owners in a unit may have done more to develop production than others. In order to recognize the greater investments of those who have already done more development work than their share in the unit, adjustments have to be made when the unit is organized. Sometimes these adjustments take the form of cash payments which generally produce an immediate tax impact to the recipient. Therefore, often those parties who have expended more than their share of the costs of development are permitted to retain a larger share of production from the properties until they have recouped their excess investment. This has the effect of spreading the adjustment over the period of time during which the funds are realized from production and also will tend to allow greater percentage depletion to the owner of the more highly developed properties and

correspondingly less to the owner of the less developed properties. The revenue is not hurt since the income is bound to be reported by one of the participants or the other. Inasmuch as the unitization of mineral properties ought to be encouraged because it leads to more efficient and less expensive production, an exception for production payments used in connection with poolings and unitizations of mineral properties to adjust the pro rata investments of participants seems justified.

SECTION 501(c) OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 615 AND 617

NATURAL RESOURCES - MINING AND EXPLORATION EXPENDITURES

Present Law

Present law allows a taxpayer to elect to deduct, without dollar limitation, mining exploration expenditures (that is, exploration expenditures for any ore or mineral other than oil or gas) which are made prior to the development stage of the mine. The availability of this deduction is limited to mines located in the United States or on the outer continental shelf. When a mine reaches the producing stage, the exploration expenditures previously deducted are recaptured, generally by disallowing the depletion deduction with respect to the mine.

A taxpayer who does not elect this unlimited mining exploration expenditure deduction is allowed a limited deduction for exploration expenditures (whether on domestic or foreign mines) without the recapture rules applying. The total deduction under this limited provision for all years may not exceed $400,000.

The allowance of a current deduction for exploration expenditures without applying the recapture rules in the case of expenditures for which the limited deduction is available provides more generous treatment than in the case of most mineral producers which are under the unlimited deduction provision.

Proposed Change

The Bill provides that the general recapture rules of present law are to apply to mining exploration expenditures which are deducted under the limited provision of present law. Thus, a deduction will continue to be allowed for foreign or

oceanographic explorations under the limited provision, but the general recapture rules will apply with respect to these expenditures.

AICPA Comments

Section 501(c)(1) of the Bill would amend Code section 615 to provide that all expenditures after July 22, 1969, to which section 615 applies would be subject to the recapture provisions of Code section 617. Expenditures made prior to July 23, 1969, are included in determining the $400,000 limitation under section 615. Section 501(c)(2) of the Bill would amend Code section 617 to permit in the case of foreign and oceanographic explorations deductions to the extent the expenditures do not exceed $400,000, reduced by the total of expenditures previously deducted under Code sections 615 and 617.

We support the approach of the Bill. However, present Code section 615(f) provides that a taxpayer who has elected either section 615 or section 617 and has not revoked the election cannot elect to apply the other section. The present Bill if enacted may cause inequities to taxpayers who made an election under either Code section 615 or section 617 whereas if they had known of the proposed amendments, they might have elected otherwise. Although the time within which to revoke the elections under section 615 or section 617 has not yet expired (see section 615(e)), provision should be made in the proposed amendments to protect those taxpayers who have made elections. The amendments should permit new elections to be made, and provide that this right does not expire until after the final regulations with respect to the

Bill section 501(c) amendments have been published in the Federal Register (last day of the third month following publication, for example). The reason for such a lengthy period of time to make the new election rests on the fact that the new election should be made only after the taxpayer is fully informed of the position the Internal Revenue Service may take in the final regulations.

SECTION 512 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 1211 and 1212

CAPITAL LOSSES OF INDIVIDUALS

Present Law

Under present law, both individual and corporate taxpayers may deduct capital losses to the extent of their capital gains. In addition, if an individual's capital losses exceed his capital gains, he may deduct up to $1,000 of the excess loss against his ordinary income. Any remaining loss may be carried forward for an unlimited number of years and deducted against ordinary income provided it is not offset by capital gains. On the other hand, where an individual has a net long-term capital gain rather than a net capital loss, a maximum of only one-half of the net long-term capital gain is subject to tax.

If a husband and wife each have capital transactions and a joint return is filed, their respective gains and losses are treated as though they had been realized by only one taxpayer and are offset against each other. On the other hand, when both spouses have capital losses and file separate returns, each spouse is allowed to deduct up to $1,000 of net capital losses from ordinary income. Thus, by filing separately, a married couple may receive a total capital loss deduction against ordinary income of $2,000.

The present treatment of long-term capital losses is inconsistent in the case of individuals with the treatment of their long-term capital gains. Although a maximum of fifty

cents of each dollar of long-term capital gains is subject to ordinary tax, when capital losses exceed capital gains, the excess loss is deductible dollar-for-dollar against ordinary income (up to a maximum of $1,000).

In addition, when it is more advantageous to them, married couples can file separate returns, be treated as two separate taxpayers, and each be allowed to deduct up to $1,000 of capital losses from ordinary income. This treatment is permitted even though married couples are generally treated as one taxpayer. This treatment of losses tends to provide an advantage for people living in community property states because all gains and losses from community property are attributable in equal amounts to each of the spouses by operation of community property law and, therefore, they are automatically eligible for the benefit of the double deduction. On the other hand, spouses living in noncommunity property states must have separate losses in order to claim this advantage—hence, they must either sell assets held in their joint names or each must sell his own assets.

Proposed Change

The Bill provides that only 50 percent of an individual's long-term capital losses may be offset against his ordinary income. (Short-term capital losses, however, would continue to be fully deductible.) In addition, the deduction of capital losses against ordinary income for married persons filing separate returns is limited by the House Bill to $500 for each spouse.

We support this section of the Bill.

SECTION 513 OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 1221

CAPITAL GAINS AND LOSSES--LETTERS, MEMORANDUMS, ETC.

Present Law

Under present law, copyrights and literary, musical or artistic compositions (or similar property) are not treated as capital assets if they are held by the person whose personal efforts created the property (or by a person who acquired the property as a gift from the person who created it). Thus, any gain arising from the sale of such a book, artistic work or similar property is treated as ordinary income, rather than as a capital gain. Collections of papers and letters prepared and collected by an individual (including papers prepared for the individual), however, are treated as capital assets. Therefore, a gain from the sale of papers of this nature is treated as a capital gain, rather than as ordinary income.

The rationale underlying the treatment provided in present law for copyrights, artistic works and similar property in the hands of the person who created them (or in the possession of a person who received the property as a gift from the person who created it) is that the person is, in effect, engaged in the business of creating and selling the artistic work or similar property.

The collections of papers and letters are essentially similar to a literary or artistic composition which is created by the personal effort of the taxpayer and should be classified for purposes of the tax law in the same manner.

Proposed Change

The Bill provides that letters, memorandums and similar property (or collections thereof) are not to be treated as capital assets if they are held by a taxpayer whose personal efforts created the property or for whom the property was prepared or produced (or by a person who received the property as a gift from such a taxpayer). For this purpose, letters and memorandums addressed to an individual are considered as prepared for him. Gains from the sale of these letters and memorandums, accordingly, are to be taxed as ordinary income, rather than as capital gains.

We support this section of the Bill.

SECTION 514 OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 1222

HOLDING PERIOD OF CAPITAL ASSETS

Present Law

Capital gains on assets held longer than six months are considered long-term gains.

Proposed Change

The Bill provides that a long-term capital gain is to be a gain from the sale or exchange of a capital asset held for more than 12 months.

AICPA Comments

Admittedly, the proposed 12 month holding period is arbitrary. We do feel however, that it is desirable to lengthen the six month period. We believe that a holding period beyond six months would more accurately indicate the intention to invest and thereby serve more closely Congressional intent that special tax treatment be afforded gains from investment as distinguished from speculative gains.

SECTION 515 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 402, 403 and 72

CAPITAL GAINS AND LOSSES--TOTAL DISTRIBUTION FROM QUALIFIED PENSION, ETC., PLANS

Present Law

An employer who establishes a qualified employee pension, profit-sharing, stock-bonus or annuity plan is allowed to deduct contributions to the trust, or if annuities are purchased, the employer may deduct the premiums. The employer contributions to, and the earnings of, a tax-exempt trust generally are not taxed to the employee until the amount credited to his account are distributed or "made available" to him. Retirement benefits generally are taxed as ordinary income under the annuity rules when the amounts are distributed, to the extent they exceed the amounts contributed by the employee. Thus, employee contributions to a pension, etc. fund are not taxed when received since these amounts were contributed from after-tax dollars of the employee.

An exception to the general rule of ordinary income treatment of pension benefits, however, provides that if an employee (except a self-employed person) receives his total accrued benefits in a distribution within one taxable year on account of separation from service or death, the distribution is taxed as a capital gain, rather than as ordinary income.

If part or all of this total distribution consists of employer securities, the employee is not taxed on the net unrealized appreciation in the securities at the time of distribution but instead only when the stock is subsequently sold by the employee.

The employee is taxed only on the portion of the employer securities attributable to the employer's cost at the time of the contribution to the trust. Furthermore, this portion is taxed at the long-term capital gain rate, rather than at ordinary income rates.

The capital gain treatment of lump-sum pension distributions was originally enacted in the Revenue Act of 1942 as a solution to the so-called bunched-income problem of receiving an amount in 1 taxable year which had accrued over several years.

The capital gain treatment afforded lump-sum distributions from qualified pension plans usually allows employees to receive deferred compensation at a more favorable tax rate than other compensation received for services rendered.

Proposed Change

The Bill limits the extent to which capital gain treatment will be allowed for lump-sum distributions from qualified employees' trusts made within 1 taxable year. Capital gain treatment is to be limited to the amount of the total distribution in excess of employer contributions.

The Bill also provides for a special 5-year "forward" averaging of the amounts to be treated as ordinary income. The taxpayer computes the increase in tax as a result of including 20 percent of the ordinary income amount of the distribution in his gross income for the taxable year in which the total distribution is made, and then multiplies the increase in tax by 5 to obtain his tax liability on the ordinary income portion. The Bill

further provides that the taxpayer may recompute his tax on the ordinary income portion at the end of 5 years by adding 20 percent of the amount in the gross income in each of the 5 taxable years, and if this method results in a lower tax than previously paid, he is entitled to a refund.

We support this section of the Bill.

SECTION 516(b) OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 1231

CAPITAL GAINS AND LOSSES--CERTAIN CASUALTY LOSSES UNDER SECTION 1231

Present Law

Generally, under present law if the gains on the disposition of certain types of property exceed the losses on this same type of property, in effect, the excess is treated as long-term capital gain. On the other hand, if the losses exceed the gains, then the net loss is treated as an ordinary loss. The types of property subject to this provision generally are depreciable property and real estate used in a trade or business and capital assets which are involuntarily converted.

An exception to this general provision is provided for uninsured losses resulting from casualty or theft in the case of property used in a trade or business (or capital assets held for the production of income). These uninsured losses are deductible in full against ordinary income rather than being required to be netted with other gains and losses under Code section 1231.

The exception to the general section 1231 rule has led to anomalous results. A business taxpayer with a casualty loss on two similar business properties, one of which is insured and one of which is not, is allowed to deduct the uninsured loss in full against ordinary income and at the same time is allowed to treat the gain on the insured property (the excess of the amount of insurance received over his adjusted basis in the property) as a capital gain. In other words, the gain and loss do not have to be netted under section 1231. On the other hand, the netting is required where the business taxpayer only partially (perhaps

5 percent) insures a business property.

Another problem that has arisen under section 1231 is whether it is applicable to casualty losses on uninsured personal assets.

Proposed Change

Casualty (or theft) losses on depreciable property and real estate used in a trade or business and on capital assets held for the production of income are to be consolidated with casualty (or theft) gains on this type of property. If the casualty losses exceed the casualty gains, the net loss, in effect, will be treated as an ordinary loss (without regard to section 1231). On the other hand, if the casualty gains exceed the casualty losses, then the net gain will be treated as a section 1231 gain which must then be consolidated with other gains and losses under section 1231. This rule is to apply where the casualty property is uninsured, partially insured or totally insured.

The Bill also clarifies the fact that uninsured casualty losses on personal assets are subject to the basic section 1231 provisions.

We support this proposed amendment to the Code.

SECTION 516(c) OF THE BILL--PROPOSED CODE SECTION 1252

CAPITAL GAINS AND LOSSES—TRANSFERS OF FRANCHISES

Present Law

The substantial growth of franchising throughout the United States in recent years has raised two significant problems: first, whether transfers of franchises are sales or licenses or, more particularly, whether the retention of powers, rights or a continuing interest in the franchise agreement is significant enough to preclude a sale; and, second, whether franchisors are selling franchises in the ordinary course of business.

The first problem is not dealt with specifically under present law, and must be resolved under general tax principles. Although section 1221 of the Code deals with property held for sale to customers, it does not appear that its relation to franchises has been fully explored by the courts.

Since present law does not specifically deal with these matters, and since there appears to be considerable diversity of opinion among the courts as to whether the transfer of a franchise constitutes a license or a sale and whether part or all of sale of a franchise constitutes the sale of a capital asset, the Bill attempts to clarify these problems.

Proposed Change

The Bill adds a new section to the Code providing that the transfer of a franchise is not to be treated as a sale or exchange of a capital asset or of property to which section 1231 applies, if the transferor retains any significant power, right or continuing interest with respect to the subject matter of the franchise.

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The general rule is not to apply with respect to amounts received or accrued, in connection with a transfer of a franchise, which are attributable to the transfer of all substantial rights to a patent, trademark or trade name (or the transfer of an undivided interest therein which includes part of all such rights), to the extent the amounts are separately identified and are reasonable in amount. These amounts, as is the case with the transfer of a patent under Code section 1235, would be entitled to capital gains treatment.

We support this proposed amendment of the Code.

CAPITAL GAINS AND LOSSES--EFFECTIVE DATE

General Comment

The effective date for the capital gain and loss provisions of the Bill is generally July 25, 1969. This date can impose serious tax penalties for those sales or dispositions which are made after July 25, 1969 pursuant to action taken prior to that date. We therefore suggest that the effective date be established at December 31, 1969, or, in the alternative, eliminate from the provisions of the Bill any transactions to which the seller was committed in writing on or before July 25, 1969. Further, we suggest that insofar as the repeal of the alternative capital gains tax for individuals and the character of the gain is concerned, collections or other dispositions in connection with transactions in which the installment method was elected should be treated as if they occurred on or before July 25, 1969.

SECTION 521 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 167 and 1250

REAL ESTATE DEPRECIATION

Present Law

Under present law, the first owner may take depreciation allowances for real property under the double declining balance method or the sum of the years digits-method. These rapid depreciation methods generally permit large portions of an asset's total basis to be deducted in the early years of the asset's useful life. A subsequent owner is permitted to use the 150 percent declining balance method which also provides more rapid depreciation than straight line in the early years.

Depreciation is allowed on the total cost basis of the property (minus a reasonable salvage value), even though the property was acquired with little equity and a large mortgage.

Net gains on sales of real property used in a trade or business are, with certain exceptions, taxed as capital gains and losses are treated as ordinary losses. Gain on the sale of buildings is taxed as ordinary income to the extent of depreciation taken on that property after December 31, 1963, if the property has been held not more than 12 months. If the property has been held over 12 months, only the excess over straight-line depreciation is "recaptured". That amount is reduced after 20 months, at the rate of 1 percent per month, until 120 months, after which nothing is recaptured.

The present tax treatment of real estate has been used by some individuals as a tax shelter to escape payment of tax on substantial portions of their economic income. The rapid

depreciation methods now allowed make it possible for taxpayers to deduct amounts in excess of those required to service the mortgage during the early life of the property.

Proposed Change

Under the Bill the most accelerated methods of real estate depreciation (the 200 percent declining balance and the sum of the years digits methods) are limited to new residential housing. To qualify for such accelerated depreciation at least 80 percent of the income from the building must be derived from rentals of residential units. Other new real estate, including commercial and industrial buildings, is to be limited to the 150 percent declining balance depreciation method. In general the new rules will not apply to property if its construction began before July 25, 1969, or if there was a written binding contract to construct the building before July 25, 1969.

Only straight line depreciation is to be allowed for used buildings acquired after July 25, 1969. A special 5-year amortization deduction is provided under certain conditions in the case of expenditures after July 24, 1969, however, for the rehabilitation of buildings for low-cost rental housing.

Finally, the Bill provides for the recapture of the excess of accelerated depreciation over straight line depreciation on the disposition after July 24, 1969, of depreciable real property (but only to the extent of depreciation taken after that date). Thus, to the extent of this excess depreciation, the gain on the sale of the real property will be treated as ordinary income rather than as capital gain.

We support this section of the Bill.

SECTION 541 OF THE BILL--PROPOSED CODE SECTION 1379

SUBCHAPTER S CORPORATIONS

Present Law

Subchapter S of the Code was enacted in 1958 to provide tax relief for small business corporations. These provisions do not deal with employee retirement plans; consequently, Subchapter S corporations may establish corporate retirement plans for the benefit of shareholders who are also employees of the corporation.

Prior to 1962, self-employed persons (proprietors and partners) were not able to establish such plans to benefit themselves. In 1962, however, Congress enacted the Self-Employed Individuals Retirement Act (H.R. 10), permitting self-employed persons to be treated as employees of the businesses they conduct so that they may be covered under qualified employees retirement plans in much the same manner as their employees. These provisions, though, contain certain specific requirements as to proprietors and partners which limit contributions to 10 percent of the proprietor's or partner's earned income, or $2,500, whichever is less.

The H.R. 10 limitations on retirement income plans described above do not apply to corporations.

Proposed Change

The Bill provides limitations, similar to those contained in H.R. 10, with respect to contributions made by Subchapter S corporations to the retirement plans for those individuals

who are "shareholder-employees," defined as employees or officers who own more than 5 percent of the corporation's stock. Under the Bill, a shareholder-employee must include in his income the contributions made by the corporation under a qualified plan on his behalf to the extent contributions exceed 10 percent of his salary or $2,500, whichever is less.

AICPA Comments

We strongly support the objective of achieving similarity of tax treatment as between shareholders of electing corporations and partners. If parallel treatment of retirement plans is required to attain this goal, it would be acceptable. However, we believe that the rules governing self-employed retirement plans presently are overly restrictive and that a change to align the treatment of electing corporations with them would be a move in the wrong direction. Rather, we urge that the rules governing self-employed retirement plans be amended to make them more nearly comparable to those covering corporate executives.

In the event the principle of the Bill is accepted in its present form by your Committee, we believe that modification in the treatment of forfeitures should be included.

A separation will have to be made between forfeitures applicable to contributions made, while an electing small business corporation, in years beginning prior to January 1, 1970 and those forfeitures applicable to contributions made on or after that date. This imposes an administrative burden on the trustees but it is one that is necessary to prevent a shareholder - employee from receiving a greater contribution than allowable under proposed

Code section 1379(b). An alternative plan which we suggest and which could reduce this burden would be to allow forfeitures to be credited to the shareholder-employee with any excess of the aggregate share of forfeitures applicable to contributions for years beginning after December 31, 1969 plus the share of contributions for such years over the lesser of (A) 10% of compensation or (B) $2,500 limitation being included in gross income by the shareholder-employee.

In connection with forfeitures, the Bill simply refers to forfeitures attributable to contributions, with no mention made of the earnings (or loss) applicable to such contributions. We believe that the term forfeitures should apply to contributions adjusted for earnings (or losses) since the dates of such contributions.

Proposed section 1379(c) prohibits carryovers of unused contributions from Subchapter S years to nonsubchapter S years. Code section 404(a)(3)(A) should be amended to conform.

SECTION 801 OF THE BILL--PROPOSED AMENDMENT TO CODE SECTION 141

INCREASE IN STANDARD DEDUCTION

Present Law

Under present law, a taxpayer may deduct his personal exemptions and also either his itemized deductions or the standard deduction in order to determine his taxable income. The standard deduction is the larger of the 10-percent standard deduction (10 percent of adjusted gross income) or the minimum standard deduction, but in neither case may it exceed $1,000 ($500 in the case of a married individual filing a separate return).

The 10 percent standard deduction was introduced in 1944 to reduce the complexity of the income tax for the vast majority of taxpayers. Instead of keeping records of deductible personal expenditures and itemizing deductions on their tax returns, more than 82 percent of taxpayers were able to use the simpler standard deduction when it was first introduced.

The combined effect of increased personal expenses and rising incomes has reduced the proportion of taxpayers using the standard deduction from over 82 percent in 1944 to an estimated 58 percent in 1969.

Proposed Change

It is desirable to simplify the preparation and auditing of individual income tax returns by increasing the number of taxpayers using the standard deduction. For this reason and to provide tax reduction to middle-income taxpayers the Bill increases the standard deduction to 15 percent with a $2,000 ceiling in three stages.

The Bill provides that the standard deduction will be 13 percent with a $1,400 ceiling in 1970, 14 percent with a $1,700 ceiling in 1971 and 15 percent with a $2,000 ceiling in 1972.

We support this proposed amendment to the Code.

SECTION 801 OF THE BILL--PROPOSED AMENDMENTS TO CODE SECTIONS 3 and 141

LOW INCOME ALLOWANCE

Present Law

The minimum standard deduction was enacted by Congress in 1964 to relieve from income tax persons with low incomes. While the action taken in 1964 providing for the minimum standard deduction provided some relief for low-income individuals, it still left some 5.2 million returns at or below the recognized "poverty level" who are still paying income taxes.

Proposed Change

The Bill supplements what in the past has been called the "minimum standard deduction" to raise the minimum amount of exempt income for a family unit to $1,100, plus the number of $600 exemptions available to the family unit.

Under the bill for 1970, the new "low income allowance" consists of an amount called the "basic allowance" (formerly known as the minimum standard deduction) and the "additional allowance" (the new feature added by this Bill). The basic allowance (as is true of the minimum standard deduction under present law) generally amounts to $200, plus $100 for each personal exemption allowed to the taxpayer up to a total of $1,000.

Thus, in the case of a single person entitled to one exemption the amount added to the $300 basic allowance is $800; in the case of a family unit of two members, the amount added to the $400 available under the basic allowance, is $700. As the amount of the basic allowance increases (by $100 for each exemption), the additional allowance added by this Bill (in order to maintain a uniform $1,100 of tax-free income per family unit) decreases (by $100)

In 1970 only, the Bill provides a phase-out of the low income allowance, to the extent it exceeds the present minimum standard deduction. This excess is to be reduced by $1 for each $2 that the taxpayer's gross income exceeds the nontaxable income level. The phase-out is repealed after calendar year 1970.

We support this proposed amendment to the Code.

SECTION 802 OF THE BILL--PROPOSED CODE SECTION 1348

MAXIMUM TAX ON EARNED INCOME

Present Law

Under present law, the individual income tax rates reach a maximum of 70 percent for taxable income in excess of $100,000 for single persons and $200,000 for joint returns. The 70 percent rate is applicable to all taxable income other than capital gains subject to the alternative rate of 25 percent.

The high rates are, in part, responsible for attempts to shelter income from tax and for the diversion of considerable time, talent and effort into "tax planning" rather than economically productive activities.

Proposed Change

The Bill provides that the maximum marginal tax rate applicable to an individual's earned income is not to exceed 50 percent. This is, in effect, an alternative tax computation for earned income under which earned taxable income in the taxable income brackets where the tax rate would otherwise be greater than 50 percent is subject to a flat 50 percent rate.

We support this section of the Bill.

Testimony on H.R. 13270, Tax Reform Act of 1969

presented in the interest of

Investors in Mutual Funds under Periodic-Payment Plans

by

Richard L. Goldman, Tax Counsel
Association of Mutual Fund Plan Sponsors, Inc.

to

Senate Finance Committee
Washington, D.C.

October 2, 1969

SUMMARY OF POINTS

A proposed Sec. 517 is needed in the Tax Reform Bill, after "other changes in capital gain treatment".

It is needed to avoid threat of two capital gain taxes on one gain, and perhaps one tax on no gain. It is a perfecting amendment, involving no revenue loss.

It would protect small and unsophisticated investors who accumulate mutual fund shares under a periodic payment plan (by which they may invest, for example, $25 a month for a period of years).

When one investor liquidates his interest under the plan (his shares being sold back to the issuing fund by the bank custodian to give him his cash), his gain is taxed to him, as is proper. But it may be taxed a second time because the investors are considered an "association" equal to a corporation for tax purposes and the "association" is regarded as having sold the fund shares and realized a gain. The association, electing to be a "regulated investment company", should not be taxable on the gain because it is distributed. But the gain is threatened with being treated as if not distributed, for technical tax reasons. The second tax would be borne in effect by the other, continuing investors not interested in the gain. A prior threat of double tax was done away with in 1964, and Congress indicated that one person's liquidating gain should not be taxed to others.

In another instance, there could be a gain tax on no gain at all.

The perfecting amendment would abolish "association" status for such investors. They are unrelated and the action of one should not affect the tax status of the rest.

Testimony on H.R. 13270, Tax Reform Act of 1969
presented by
Richard L. Goldman, Tax Counsel
Association of Mutual Fund Plan Sponsors, Inc.

October 2, 1969

INTRODUCTION

Mr. Chairman, and distinguished members of the Committee, I appreciate the privilege of making this Statement to you.

I am Richard L. Goldman. I am tax counsel to the Association of Mutual Fund Plan Sponsors, Inc. The Association is an organization of mutual fund underwriters which sponsor periodic-payment plans for the accumulation of mutual fund shares. Under each plan, investors make monthly payments to accumulate shares of a designated fund. Typically, an investor may pay $25 a month for 10 years. The payments are made to a bank custodian, which buys shares of the issuing fund from the fund and holds them for the respective accounts of the investors.

There are nearly 2,000,000 such investors. Usually, they are small investors and unsophisticated ones.

NEED FOR CORRECTIVE AMENDMENT

A perfecting amendment is needed because these investors are threatened with two capital gain taxes on one gain -- one of the taxes being levied, still more remarkably, on investors other than the one who is entitled to the gain -- and, conceivably, they are threatened with one gains tax on no gain at all.

In a tax reform bill, there should be room to reform such a situation. A draft of amendment is submitted with this Statement.

NO REVENUE LOSS

No revenue loss would result, and no opposition has been encountered. We have submitted the draft of amendment to the Treasury, and to Dr. Woodworth and his staff. There has been some study by each office, and we have responded to questions.

NATURE OF THE INVESTORS' TAX TRAP: "ASSOCIATION" STATUS

At present, periodic-payment investors, though unrelated and having nothing in common, are lumped together for tax purposes as an "association" equivalent to a corporation, required to file corporate returns and subjected to certain corporate rules. The corporate rules are inappropriate, when applied here, and can lead to unbelievably wrong results. This is so even though "regulated investment company" treatment is elected and should avoid such results.

For example, suppose that an investor wishes to liquidate his interest under the periodic-payment plan. Let us assume his fund shares have a cost of $2,000 and present value of $5,000. He terminates his periodic-payment program, ordering the bank custodian to sell his shares back to the fund and distribute the proceeds to him including his gain of $3,000. He is taxable on the gain, of course, and rightly so. But the "association", regarded as acting through the bank, has sold the shares technically realizing a gain to it of $3,000. Tax on the gain at the association level can be avoided, under the so-called "pass-through" treatment allowed to a regulated investment company, but only if the gain is honored as having been distributed. This is because a regulated investment company gets a deduction for distributions paid (Code Sec. 852(b)(3)) so as to be taxed only on gains which are not distributed. Unfortunately, our "association" may not get this deduction even though the gain actually is distributed.

This would leave the gain subject to tax, not only to the liquidating investor, but again at the association level to be borne by the other, continuing investors who are not entitled to his gain.

Thus in 1964, it was suggested that the gain could not be regarded as distributed -- that is, the deduction would not be allowable to the association -- because the distribution, though actually made, was "preferential" unless made pro rata to all the investors under the periodic-payment plan including those not entitled to the gain. It may be explained that the deduction itself was conceived originally for "personal holding company" purposes, and for those purposes was not to be allowed if made "preferentially" to one shareholder instead of all. (Secs. 561, 562.) But these rules have been extended into the regulated investment company area, to afford pass-through treatment. As extended into this area, they work imperfectly. It seemed to do no good to suggest

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to the Service that one person's gain could not be divided among the others as well, and that the others had no gains which could be the subject to a pro rata distribution to them, too. This, as just stated, threatened to leave the liquidating investor's gain taxable also to the other, non-liquidating investors.

That view seemed senseless. Indeed, the last investor would have lost his entire investment through taxes on other people's gains.

Fortunately, the Revenue Act of 1964 -- by action initiated by this Committee -- corrected the situation by adding to the Code Section 852(d), which provides against disregarding a distribution as "preferential" where an investor is liquidating his interest under a periodic-payment plan.

The same problem has cropped up again, in another form. It has been indicated, at the Internal Revenue Service, that the distribution to the liquidating investor still may be disregarded, in spite of the 1964 legislative record reflecting, in so many words, Congress' intention that a liquidating investor's gain is not to be taxed to the continuing investors too.

The theory now suggested is that if the liquidating investor owns, for example, 1% of all the fund shares held under the periodic-payment plan, then only 1% of his gain could be regarded as distributed to him because (likening his case to that in a real corporation) there is a sort of redemption of his equity interest in the "association" and, under rules applicable to real corporations, when a corporation redeems a fraction of its outstanding stock only the same fraction of its profits can be regarded as distributed. The balance remains on the books, for tax purposes, so as to give rise to dividend treatment upon future distribution. This would mean, where periodic-payment investors in a mutual fund are imagined to be an "association", that 99% of the liquidating investor's gain would be regarded as undistributed -- leaving that 99% subject to tax at the association level as well as to the liquidating investor, but this time to be borne by the other investors.*

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*1% of the dividends received during the year by the "association" would have to be regarded as distributed to the liquidating investor, too. He would still get only capital gain treatment, under the analogy to corporate stock-redemption rules. But this would mean that although 100% of dividends received by the bank custodian are distributed to the periodic-payment investors, as required under the plan, the imaginary association would be regarded as having a lesser amount in profits--so that the excess of dividends over profits would have to be treated as a return of capital, avoiding dividend tax.

Thirdly, it has been suggested that an investor merely withdrawing the fund shares credited to his account -- that is, terminating his periodic-payment program and taking out his fund shares in kind -- would be terminating a sort of "stock" interest in the association, this time for a distribution in kind, but nevertheless equivalent to a stock redemption by a real corporation. Under stock redemption rules (Code Sec. 302), that would mean that he would be taxed on the value of his fund shares in excess of his cost basis -- on the appreciation in the shares he would be withdrawing -- even though he would merely be in the same position as shareholders directly holding shares in the fund. He would not have cashed in his investment, which might fall in value (or rise further), yet he would be regarded as if he had closed out his investment and be taxed.

Such threatened tax treatments do not comport with economic reality; or with the public's understanding; or with a sensible reading of the Internal Revenue Code in light of Congress' underlying policies. They make no sense, in short.

SOLUTION AFFORDED BY THE PROPOSED AMENDMENT

These problems arise repeatedly. They arise because of flaws in the law, as administered, growing out of the imagined assumption that total strangers have been "associating" with each other like people who knowingly invest in a real industrial corporation.

Our amendment would do away with "association" treatment: the corporate rules would not apply.

Instead, each investor would be regarded as owning his fund shares directly, through the bank custodian as a mere nominee. It would be the same as if the shares were held by a brokerage house in "street name", for the investor as real owner.

This would simplify the tax law, and --

(1) save the investors from threat of unintended double taxes on capital gains, or single taxes on no gains;
(2) save the Service from having to administer a technical maze of rules producing no revenue; and
(3) conform the tax law to reality as the public knows it, and to the policy intended by Congress.

WHY UNRELATED INVESTORS ARE TREATED AS AN "ASSOCIATION"

The technical reason for treating periodic-payment investors as an "association" equivalent to a corporation is that the bank, serving as custodian as required under S. E. C. rules, is regarded as if it were a central management like the President and Board of Directors of a real corporation.

In fact, the bank custodian does not manage at all. The fund is specified in the prospectus of the periodic-payment plan as the investment medium and it cannot be changed except, under S. E. C. rules, in an emergency.*

INVESTORS NOT TO BE RE-CLASSIFIED AFTER THE AMENDMENT AS SOME OTHER ENTITY, SUCH AS "TRUST" OR "PARTNERSHIP"

The proposed amendment would, if adopted, prevent any imaginary form from being imputed to the periodic-payment investors. No association or corporate form would be imagined, as already discussed. Also, there would be no "partnership" or "trust".

This is because our hope is to have done with this imaginary-entity problem once and for all. We do not want to have to come back and bother this Committee a third time, having been here in 1963-64 and again now.

Also, in a very few cases the investors seem to be regarded as a large group "trust". The Service view

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* Such as failure of the mutual fund, or its ceasing to offer shares. No change to a new fund could be made for an investor if he objected.

The sponsor company (that is, the underwriter distributing shares of the fund under the periodic-payment plan) contracts to make the fund's shares continually available. If it fails to act, the bank has to step in. The bank serves as a watchdog for investors presumed to be unable to act readily for themselves. The bank would have to find another sponsor company or itself act as sponsor; or if the fund shares were no longer available to be purchased, it would select a different fund -- giving the investor notice and an opportunity to object. An objection would have to be honored.

is that an investor liquidating his interest in such a group trust can have a deductible loss even if he merely withdraws his fund shares.* This implies a threat that he could have a taxable gain by merely withdrawing the fund shares, even though he would not really be ending his investment.

LIMITED SCOPE OF AMENDMENT

The amendment is intended only for periodic-payment plans for the purchase of shares of a single mutual fund, not various funds. The amendment would apply if some emergency requires discontinuing purchasing shares of one fund, and switching to another.

But it would not apply to any so-called "fund of funds" in which a portfolio is actively managed, and which is set up on a periodic-payment basis. There has been indication of Treasury concern over this, and of a desire to limit the scope accordingly. (Of course, in our usual case, a single fund is designated in the prospectus and S. E. C. rules would prevent shifting to other funds on an actively-managed basis.)**

EFFECTIVE DATES.

The proposed perfecting amendment should apply in 1969, to do the job best.

No taxable event would result from enactment of the perfecting amendment. Periodic-payment investors would no longer be regarded as in a plan "association" for tax purposes. But there would not be any actual event, of liquidating the "association", so as to give rise to tax.

PLACE OF AMENDMENT IN THE BILL

The perfecting amendment could be added as Sec.

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* Rev. Rul. 68-633, 1968-50 I. R. B. 15.

** Similarly, the amendment should not apply where the investment medium of the periodic-payment plan is a managed portfolio of industrial stocks. A few mutual funds are set up on this basis, rather than as a corporation, and there is no occasion to change their tax treatment.

However, there are a few plans for the accumulation of shares of a designated industrial corporation, specified in the governing prospectus. (Sponsors of such plans are not members of our Association.) Covering those plans in this amendment appears appropriate, and has, therefore, been provided.

517 of the Tax Reform Bill, immediately after "Other Changes in Capital Gain Treatment" (Sec. 516, at page 300).

That positioning would be appropriate, since the corrective effect will be on capital gain treatment.

-END-

TEXT OF AMENDMENT

SEC. 517. PERIODIC PAYMENT PLANS TO INVEST IN MUTUAL FUNDS.

(a) Section 852 of the Internal Revenue Code of 1954 (relating to special rules for the income tax treatment of regulated investment companies and their shareholders) is amended by adding at the end thereof the following new subsection:

"(e) For purposes of this title:

"(1) the terms 'corporation,' 'partnership,' and 'trust' shall not be construed to mean or include a unit investment trust (as defined in the Investment Company Act of 1940)--

"(a) which is registered under said Act and issues periodic payment plan certificates (as defined in said Act), and

"(b) substantially all of the assets of which, or of each series of which, consist of securities issued by a management company (as defined in said Act) or issued by a single other corporation;

"(2) notwithstanding that such assets shall be held by and/or registered in the name of (or in the name of a nominee of) a trustee, or custodian, contemplated by section 26(a)(1) of said Act, each holder of an interest in such unit investment trust, to the extent of such interest, shall be regarded as owning such assets directly through such trustee, or custodian, as mere nominee acting on behalf of such holder;

"(3) the basis of such assets to such holder shall be the same as that of such interest; and

"(4) in determining the period for which such holder has held such assets, there shall be included the period for which he held such interest if such assets have the same basis, in whole or in part, in his hands as such interest under paragraph (3) of this subsection."

(b) Effective Date. The amendments made by subsection (a) shall apply with respect to taxable years of such unit investment trust ending after December 31, 1968 and with respect to taxable years of such holder in which such ending date shall be included. No taxable event shall be deemed to result from such application.

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Our firm prepares tax returns for 10,000 middle income taxpayers per year. Based on the proposed 1969 Tax Reform Bill (HR 13270) our clients would receive only a very limited tax relief by the increase in the standard deduction. Further using the statistics available through the Internal Revenue Service the average taxpayer who itemized deductions would receive no benefit, in either simplicity of filing or in reduction of taxes.

Description of Statistical Techniques Used

Using an IBM 1130 computer all data on all our clients was analysed according to the effect of the adoption of the proposed standard deduction. Our clients are divided according to adjusted gross income as follows:

0- 1000	0.5%	12000-13000	5.8%
1000- 2000	2.0%	13000-14000	5.6%
2000- 3000	3.4%	14000-15000	7.5%
3000- 4000	3.0%	15000-16000	1.5%
4000- 5000	4.7%	16000-17000	2.8%
5000- 6000	8.1%	17000-18000	3.9%
6000- 7000	8.5%	18000-19000	3.5%
7000- 8000	9.1%	19000-20000	3.0%
8000- 9000	5.6%	20000-21000	1.5%
9000-10000	4.3%	21000-22000	0.5%
10000-11000	5.0%	22000-23000	1.2%
11000-12000	5.3%	23000-24000	1.2%
		24000 plus	2.1%

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Data cards for all clients were analyzed to determine the number of clients who used the percentage standard deduction in 1969. This represented 7.2% of all clients. Using the same data cards from 1969 we analyzed the number of clients who would have used a 13%(1400.-maximum) standard deduction. The percentage thus using the standard deduction encreased from 7.2% to 9.0%. Using the same method we determined the percentage of clients who would use the 14%($1700.-maximum) standard deduction. The percentage thus using the standard deduction would be 11.7%. Finally we analyzed the number of clients who would have used the 15%($2000.-) standard deduction. The resultant percentage was 18.2%
According to our data their would be a cross over of 11% of our clients from itemized deductions to the new 15% standard deduction, all other data remaining constant.

Using the same data cards we then computed the total income tax, before credits and surtax, paid by all our clients in 1969. This total tax figure was $9,578,280.-
We then proposed the same question allowing for the 15%($2000.) standard deduction where such deduction would be greater than that used in 1969. In other words projected the tax revenue from our clients for 1972 under section 801: HR 13270.
The total revenue, before credits and surtax, would be $9,480,180.

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The difference would represent less than one percent tax reduction for our total clients. It should further be noted that the treasury statistics based on adjusted gross income broken down into categories as follows $5-6M; $6-7M; $7-8M; $8-9M; $9-10M; $10-15M; 15-20M; $20-50M; and $50-100M all had average itemized deductions greated than 15%.

Therefore we recommend to the Committe that the tax rates for individuals Sec. 804 be retained in order that the middle income tax payer receive some limited tax relief from the 1969 Tax Reform Law.

American Association of Retired Persons
National Retired Teachers Association

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TESTIMONY

OF

ERNEST GIDDINGS
LEGISLATIVE REPRESENTATIVE
NATIONAL RETIRED TEACHERS ASSOCIATION
AMERICAN ASSOCIATION OF RETIRED PERSONS

BEFORE

SENATE FINANCE COMMITTEE

ON

RETIREMENT INCOME CREDIT
AND OTHER MATTERS IN THE
TAX REFORM ACT OF 1969

October 2, 1969

MR. CHAIRMAN:

MY NAME IS ERNEST GIDDINGS. I AM LEGISLATIVE REPRESENTATIVE OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS. ACCOMPANYING ME IS MR. PETER HUGHES, ALSO LEGISLATIVE REPRESENTATIVE OF OUR TWO ASSOCIATIONS WHICH CONSIST OF AN INDIVIDUAL MEMBERSHIP NATIONWIDE OF APPROXIMATELY 1,800,000 OLDER PERSONS.

THE NATIONAL CONFERENCE ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS HAS ALSO AUTHORIZED ME TO SPEAK FOR THEM TODAY IN BEHALF OF AN UPDATING OF THE RETIREMENT INCOME TAX CREDIT, SECTION 37 OF THE INTERNAL REVENUE CODE.

A NUMBER OF GROUPS OF RETIREES WERE NOT COVERED BY SOCIAL SECURITY DURING THEIR WORKING YEARS. INCLUDED WERE MANY TEACHERS IN FOURTEEN STATES, POLICE, FIREMEN, CIVIL SERVICE EMPLOYEES, AND SOME OTHER CLASSIFICATIONS. GENERALLY, THEREFORE, I AM SPEAKING IN BEHALF OF THESE GROUPS AT THIS TIME.

MR. CHAIRMAN, WHEN YOUR COMMITTEE AND THE CONGRESS ENACTED SECTION 37, THE RETIREMENT INCOME TAX CREDIT SECTION OF THE REVENUE CODE IN 1954, YOU REMOVED AN OUTSTANDING INEQUITY IN THE TAX TREATMENT BETWEEN TAX-EXEMPT SOCIAL SECURITY AND RAILROAD RETIREMENT AND NON-EXEMPT RETIREMENT INCOME. WHEN YOU UPDATED SECTION 37 in 1962, YOU AGAIN PRESERVED THE

PRINCIPLE OF EQUAL TAX TREATMENT OF VARIOUS FORMS OF RETIREMENT INCOME. SINCE THIS ISSUE HAS NOT BEEN BEFORE YOUR COMMITTEE FOR SIX YEARS, I WILL DEVOTE THE NEXT FEW PARAGRAPHS TO THE EARLY HISTORY AND ORIGIN OF THE TAX CREDIT.

<u>ORIGIN OF RETIREMENT INCOME TAX CREDIT</u> IN 1954, CONGRESS ADDED TO THE TAX LAWS THE RETIREMENT INCOME TAX CREDIT. AS INDICATED IN THE REPORT MADE ON THE BILL AT THAT TIME. THE CREDIT WAS ADDED BECAUSE --

> "UNDER EXISTING LAW BENEFITS PAYABLE UNDER THE SOCIAL SECURITY PROGRAM AND CERTAIN OTHER RETIREMENT PROGRAMS OF THE FEDERAL GOVERNMENT ARE EXEMPT FROM INCOME TAX. YOUR COMMITTEE BELIEVES THAT THE TAX-EXEMPT STATUS OF SUCH BENEFITS DISCRIMINATES AGAINST PERSONS RECEIVING RETIREMENT PENSIONS UNDER OTHER PUBLICLY ADMINISTERED PROGRAMS, SUCH AS TEACHERS, AS WELL AS AGAINST PERSONS WHO RECEIVE INDUSTRIAL PENSIONS OR WHO PROVIDE INDEPENDENTLY FOR THEIR OLD AGE."

IN VIEW OF THIS SITUATION, CONGRESS PROVIDED A CREDIT AGAINST TAX WHICH IN EFFECT ALLOWED AN EXEMPTION OF RETIREMENT INCOME (AT THE FIRST TAX BRACKET RATE) PATTERNED ALONG THE LINES OF THE SOCIAL SECURITY BENEFITS WHEN PAYABLE, BUT AVAILABLE TO INDIVIDUALS ONLY TO THE EXTENT THAT THEY DO NOT RECEIVE SOCIAL SECURITY, RAILROAD RETIREMENT, OR OTHER SIMILAR TAX-EXEMPT FORMS OF INCOME.

THE FORMS OF RETIREMENT INCOME ELIGIBLE FOR THIS CREDIT ARE PENSIONS AND ANNUITIES, INTEREST, RENTS AND DIVIDENDS.

EQUAL TAX TREATMENT AGAIN PURPOSE THE RETIREMENT INCOME TAX CREDIT WAS UPDATED LAST IN 1962. AS A RESULT OF THE AMENDMENT PASSED BY THE CONGRESS AT THAT TIME, A BASE OF $1,524 WAS ESTABLISHED FOR COMPUTATION OF THE RETIREMENT INCOME TAX CREDIT.

THE FIGURE OF $1,524 WAS DETERMINED BY YOUR JOINT COMMITTEE ON INTERNAL REVENUE TAXATION AS THE MAXIMUM PRIMARY SOCIAL SECURITY BENEFIT AVAILABLE TO ANY INDIVIDUAL UNDER THE SOCIAL SECURITY PROGRAM AT THAT TIME.

SINCE THE LAST AMENDMENTS TO THE RETIREMENT INCOME CREDIT IN 1962, A NUMBER OF INCREASES HAVE BEEN MADE IN SOCIAL SECURITY BENEFITS. AS A RESULT, THE RETIREMENT INCOME CREDIT NO LONGER PROVIDES EQUAL TAX TREATMENT FOR THOSE WHO MAY BE RETIRED UNDER GOVERNMENT OR PRIVATE PENSION SYSTEMS OR MAY MAKE PROVISION THROUGH INVESTMENT INCOME FOR THEIR OWN RETIREMENT.

SPECIFICALLY, THE 13 PER CENT INCREASE IN SOCIAL SECURITY BENEFITS IN 1967 ADDED TO A FEW LESSER INCREASES BETWEEN 1962 AND 1967 JUSTIFY AN AMENDMENT TO THE TAX CODE, THIS YEAR, TO PERMIT COMPUTATION OF THE CREDIT ON THE INCREASED BASE.

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BASIC CHANGE TO AGAIN EQUALIZE THE RETIREMENT INCOME CREDIT WITH THE SOCIAL SECURITY BENEFITS, THESE CHANGES SHOULD BE MADE:

FIRST, THE MAXIMUM AMOUNT OF INCOME WHICH MAY QUALIFY AS RETIREMENT INCOME SHOULD BE RAISED FROM $1,524 TO $1,872 A YEAR. THIS LATTER FIGURE CORRESPONDS IDENTICALLY WITH THE MAXIMUM PRIMARY BENEFIT NOW AVAILABLE UNDER THE SOCIAL SECURITY PROGRAM. TO DETERMINE THE MAXIMUM RETIREMENT CREDIT, THE $1,872 IS MULTIPLIED BY 15 PER CENT. THUS, THERE WILL BE A MAXIMUM CREDIT OF $280.80 PER PERSON AS CONTRASTED TO $228.10 UNDER PRESENT LAW.

REDUCTION DUE TO EARNED INCOME THE REDUCTION MADE IN THE RETIREMENT INCOME CREDIT ON ACCOUNT OF EARNED INCOME SHOULD BE CHANGED TO CORRESPOND WITH THE CHANGES MADE IN THE EARNED INCOME REDUCTION PROVIDED IN THE SOCIAL SECURITY LAW. THUS, WHILE UNDER PRESENT LAW, EARNINGS BETWEEN $1,200 AND $1,700 A YEAR REDUCE THE TAX CREDIT BY ONE DOLLAR FOR EVERY TWO DOLLARS EARNED; UNDER A TRUELY CONFORMING AMENDMENT, EARNINGS BETWEEN $1,680 AND $2,880 REDUCE THETAX CREDIT BY THE SAME FORMULA, NAMELY, BY ONE DOLLAR FOR EVERY TWO DOLLARS EARNED.

RIBICOFF AMENDMENT WILL RESTORE EQUAL TAX TREATMENT SENATOR ABRAHAM RIBICOFF, ON SEPTEMBER 29, 1969, INTRODUCED A BILL WHICH WILL RESTORE TAX EQUITY TO THOSE PERSONS WHO DEPEND UPON

PUBLIC PENSIONS OR OTHER FORMS OF RETIREMENT INCOME IN LIEU OF SOCIAL SECURITY OR RAILROAD RETIREMENT.

THE RIBICOFF BILL IS DESIGNED TO REMOVE THE DISCRIMINATION WHICH HAS ARISEN GRADUALLY AS CHANGES HAVE BEEN MADE IN THE SOCIAL SECURITY PROGRAM WITHOUT CORRESPONDING CHANGES IN THE RETIREMENT INCOME CREDIT.

MR. CHAIRMAN, S. 2968 DOES NO MORE AND NO LESS THAN TO AGAIN ADJUST COUNTERPART SECTION 37 PROVISIONS TO CONFORM WITH EXISTING SOCIAL SECURITY LAWS.

S. 2968 WOULD INCREASE THE RETIREMENT INCOME CEILING FROM $1,524 TO $1,872 THUS CONFORMING IT WITH THE PRESENT SOCIAL SECURITY PRIMARY BENEFIT CEILING. IN THE MOST EXTREME CASE, THIS WOULD MEAN AN ADDITIONAL TAX CREDIT OF $52.70, BUT, GENERALLY, THE CREDIT WOULD AMOUNT TO APPROXIMATELY ONE-HALF OF THAT FIGURE. FURTHERMORE, WITH THE GREAT INCREASE IN SOCIAL SECURITY COVERAGE, THE NUMBER OF PERSONS USING THE RETIREMENT INCOME CREDIT IS CERTAIN TO DECLINE YEAR BY YEAR.

IN SUMMARY, I WOULD POINT OUT THAT WHILE THE DOLLAR BENEFIT IN S. 2968 IS IMPORTANT TO EVERY RETIRED PERSON, THE PRINCIPLE OF TAX EQUITY UNDER THE TAX LAWS OF OUR NATION IS OF EQUAL IMPORTANCE AND THE PASSAGE OF S. 2968 WILL AGAIN REASSURE RETIRED PERSONS THAT NONE OF THEM ARE GOING TO BE DISCRIMINATED AGAINST BY THE TAX WRITING COMMITTEES OF THE CONGRESS.

THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS RESPECTFULLY URGE

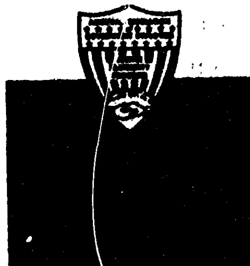
YOUR COMMITTEE TO ADOPT S. 2968, INTRODUCED BY SENATOR RIBICOFF.

American Federation of Government Employees

AFFILIATED WITH THE AFL-CIO

JOHN F. GRINER, NATIONAL PRESIDENT — CLYDE M. WEBBER, EXECUTIVE VICE PRESIDENT — ESTHER F. JOHNSON, NATIONAL SEC.-TREAS.

WASHINGTON, D. C.



STATEMENT OF JOHN F. GRINER, NATIONAL PRESIDENT
AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES
BEFORE THE SENATE COMMITTEE ON FINANCE ON
H.R. 13270, THE TAX REFORM ACT OF 1969, PROPOSING
THE EXEMPTION FROM INCOME TAX OF CIVIL SERVICE ANNUITIES
OCTOBER 2, 1969

In the name of the American Federation of Government Employees, I wish to express gratitude to the distinguished Chairman of the Senate Committee on Finance and to its other members for this opportunity to testify on the important subject of tax reform as it affects Federal employees.

Our organization which now has more than 320,000 dues-paying members and which represents more than 560,000 Federal employees in exclusive recognition units, is composed, of course, of taxpayers. Every one of our members has the Federal income tax deducted at the time he receives his Federal pay check.

These employees have become increasingly aware that certain major inequities, certain vestiges of serious tax injustice, continue to exist in current tax practices. These injustices exist in our general tax policy; they also exist in specific discrimination and selective injustice suffered by Federal employees, especially in the continuing unfair Federal practice of income taxes levied on their Civil Service annuities.

Your Committee has already received testimony from George Meany, the President of the American Federation of Labor and Congress of Industrial Organizations, regarding certain grave injustices in our general Federal tax policy, especially the failure of the "loophole set", as he described them, to bear their fair

TO DO FOR ALL THAT WHICH NONE CAN DO FOR HIMSELF

share of the tax burden. As a member of the American Federation of Labor and Congress of Industrial Organizations, we endorse the position taken by Mr. Meany and associate ourselves with him. For the sake of brevity, however, I shall not dwell upon or repeat what he has already said and I shall restrict my comments to those matters which he did not touch but which are of especial significance to us.

Tax justice, like every other kind of justice, must be based on the principle that the persons affected will be granted equitable treatment in law and in practice. Whatever the law grants to one class of citizens, the same should be granted, in similar manner, to all comparable classes.

Morever, tax justice, like every other kind of justice, should reflect the general standards and norms of contemporary society. As we know, in our society it has been accepted that it would be improper to place a heavy taxation burden on persons who are on the fringes of poverty.

Yet I must come before you today to inform you that these noble precepts of our contemporary society are not being carried out in the case of more than 870,000 human beings who were either Federal employees and are now retired or who are the survivors of Federal employees.

Annuitant beneficiaries of the Social Security system, for example, and of the system established by the Railway Retirement Act pay no income tax whatsoever on their annuities. Yet retired Federal employees and their survivors must pay this tax in full on that portion of their annuities which is derived from contributions by their Federal employer.

Our organization favors, of course, the exemptions granted so wisely by our government to pensioners of the Social Security system. When one looks at the amounts of these pensions, it is obvious that this is a humane and just course for our nation to pursue.

Our organization likewise favors and supports the provisions of the Railway Retirement Act. We are gratified that the Congress specifically exempted all income received by these annuitants from income taxation.

We must ask you, however, the following question : Are not annuitants under the Civil Service Retirement system entitled to the same kind of humane and wise consideration from their Congress and from their Federal government as beneficiaries of the Social Security system and the Railway Retirement Act?

In our judgment, the answer is obviously "yes".

Let us look at the facts.

Participation in the Social Security system is mandatory for all categories of persons covered. Participation in the Railway Retirement Act is also mandatory. But so is participation in the Civil Service system.

The Civil Service system, just like the Social Security and the Railway Retirement systems, is a mandatory system. It is not a voluntary system.

Even though the mandatory payroll deductions from earnings in the Civil Service System are technically called "contributions", the fact is that the deductions are mandatory for both the employee and the employer.

If we were to call things by their right name, we must recognize that these "contributions" are in fact a tax. And, as you know, under the terms of another Bill before the Senate, the rate of these mandatory "contributions" might soon be raised from 6.5% respectively by employee and employer to 7.0% each. Therefore, the current total tax of 13.0% of payroll may soon be 14.0%. This compares with a total current tax in the Social Security system of only 9.6% of payroll, shared equally at 4.8% each by employer and employee.

As these facts show, one can really find no meaningful legal distinction between the three systems, Social Security, Railway Retirement and Civil Service so far as mandatory contributions are concerned or the financial sharing of the burden by the employer and employee. Yet, the Civil Service annuitant must pay an income

tax on that portion derived from the Federal employer's "contribution".

We believe this is discrimination, discrimination unworthy of our contemporary society with its great emphasis on equal rights.

There are some persons who have been saying that Civil Service annuitants are in such a favorable economic position that they do not need tax justice, that they do not need tax relief.

I wish those people were right.

But they are very, very wrong.

The most recent comprehensive figures, compiled by the Civil Service Commission, show that on June 30, 1968, almost 100,000 Federal employee annuitants and survivor annuitants received less than $50.00 a month in annuities. This is less than $600.00 a year. Moreover, this amount was subject to income tax.

The statistics also show that 276,073 employee annuitants and survivor annuitants received less than $100.00 a month. This is less than $1,200.00 a year. Moreover, this was subject to income tax.

Almost 400,000 employee and survivor annuitants received less than $150.00 per month, or less than $1,800.00 per year. This too was subject to income tax.

Of the total number of 871,072 persons on the Civil Service retirement rolls on that date, 514,863 received less than $200.00 per month, or less than $2,400.00 per year. Moreover, the overwhelming number of these persons had wives or other dependents. Yet, the annuities were subject to income tax.

Other people have argued that this is largely the inheritance from the past and that the economic conditions of Federal employees currently entering the annuitant rolls are much better.

Again, I must state that they are very, very wrong. Again, I say, let us look at the facts, let us look at the statistics of those Federal employees and survivors newly added to the annuity rolls in fiscal year 1968.

During the fiscal year 1968, the following persons were added to the rolls:

A. - 19,262 widows, with an average age of 61.2 years, who receive an average annuity of $138.00 per month or $1,656.00 per year. On this income, these widows paid an income tax.

B. 10,347 children, with an average age of 14.6 years, who received an average annuity of $50.00 per month, or $600.00 per year. On this income, the parent or guardian had to pay income tax.

C. - 52,579 employee annuitants, with an average age of 60.3 years, who received an average annuity of $291.00 a month or $3,492.00 per year. The very great majority of these employee annuitants, totally 35,045 had wives and other dependents. Yet their annuities were subject to income tax.

Distinguished members of this Senate Committee, that is the very sad picture of the financial state of affairs of those Federal employees and survivor annuitants who came onto the rolls of the Civil Service annuity system for the first time in fiscal year 1968.

Yet everyone of these persons must pay income tax on that portion of his or her retirement income which comes out of funds contributed by the employer.

In my presentation, I have chosen up to now only the most representative statistics in order to illustrate the injustice suffered by Federal annuitants as a class. I could have chosen, of course, large numbers of cases of a far more pathetic and pitiable nature. There are, for example, over 1,000 widows with an average age of 75.2 years who receive a grand total of $51.00 per month, or $612.00 per year. There are, for example, widows over 75 years of age who receive $31.00 per month, or exactly $1.00 per day. Their total annual income is thus $365.00. Yet, this is subject to income tax.

I shall not burden you here with more statistics and examples. Instead, I request your permission to place into the record four tables giving the facts.

The first table shows the grand total of all annuitants on the Civil Service retirement roles as of June 30, 1968, by monthly rates of annuity. The second table shows the total number of survivor annuitants as of that date. The other two tables show the numbers of employee annuitants and survivor annuitants added to the Civil Service retirement roles during the fiscal year ending June 30, 1968.

SUMMARY AND CONCLUSION

A comparison of the Social Security, the Railway Retirement Act and the Civil Service retirement systems shows that, although all are mandatory, the Civil Service employee suffers discrimination because his annuities are subject to income tax payment on income derived from contributions of the Federal employer.

An analysis of the annual income of both the Civil Service employee and survivor annuitants reveals that an overwhelming majority are living at the poverty level. Children are receiving $600.00 per year as total income; some widows, aged 75 and over, are receiving as little as $365.00 annually or one dollar per day. Over 514,000 annuitants receive less than $200.00 per month and many of these must support wives and other dependents.

The precepts of tax justice require that we extend to Civil Service annuitants the same tax policy that now applies to Social Security and Railway Retirement Act annuitants -- total exemption from all income tax.

In the name of the American Federation of Government Employees, I again petition you to remove this vestige of tax discrimination which has been endured too long by our retired Federal employees, by their dependents and by their survivors. The great majority of them are now living at or near the poverty level and they are in urgent need of tax relief.

In conclusion, I wish again to express my appreciation for the kind courtesy you have shown to my organization by allowing me to appear before you today and for the thought and deliberation you will be giving to my petition.

Annexes:

Table 1 - Number of employee annuitants and survivor annuitants on the retirement roll as of June 30, 1968, by monthly rates of annuity

Table 2 - Survivor annuitants on the retirement roll as of June 30, 1968

Table 3 - Employee annuitants added to the retirement roll during the fiscal year ended June 30, 1968

Table 4 - Survivor annuitants added to the retirement roll during the fiscal year ended June 30, 1968

Table 1

Number of employee annuitants and survivor annuitants on the retirement roll as of June 30, 1968, by monthly rates of annuity

Monthly rates of annuity	Employee annuitants			Survivor annuitants			
	Total	Prior to Public Law 854	Under Public Law 854	Total	Prior to Public Law 854	Under Public Law 854	Under Public Law 85-465
Under $10	170	132	38	785	462	322	1
$10 to $19	3,827	3,417	410	8,775	5,999	2,716	60
$20 to $29	10,923	8,958	1,965	15,865	7,008	8,026	833
$30 to $39	12,606	8,377	4,229	18,006	5,998	10,417	1,591
$40 to $49	10,427	6,482	3,945	18,431	6,470	10,576	1,387
Subtotal--under $50	37,953	27,366	10,587	61,862	25,937	32,053	3,872
$50 to $59	14,222	8,222	6,000	37,614	6,305	29,343	1,766
$60 to $69	12,671	6,548	6,123	27,588	5,124	20,449	2,015
$70 to $79	13,072	5,781	7,291	17,150	5,354	8,893	2,903
$80 to $89	12,793	4,889	7,904	19,401	11,929	7,187	285
$90 to $99	12,930	4,448	8,482	9,017	3,347	5,141	529
Subtotal--under $100	103,661	57,254	46,387	172,632	57,996	103,066	11,370
$100 to $109	14,833	4,652	10,181	11,697	4,957	6,740	-
$110 to $119	18,239	4,751	13,488	8,761	3,186	5,575	-
$120 to $129	13,393	3,381	9,012	6,929	2,283	4,646	-
$130 to $139	16,622	3,509	13,113	10,869	3,119	7,750	-
$140 to $149	14,836	2,985	11,851	6,488	2,617	3,871	-
Subtotal--under $150	181,564	76,732	104,832	217,176	74,158	131,648	11,370
$150 to $159	16,596	3,247	13,349	6,714	2,709	4,005	-
$160 to $169	18,161	3,168	14,993	6,440	2,490	3,950	-
$170 to $179	16,934	2,609	14,325	4,022	1,236	2,786	-
$180 to $189	18,116	2,407	15,709	4,676	1,555	3,121	-
$190 to $199	20,093	3,816	16,277	4,361	1,175	3,186	-
Subtotal--under $200	271,464	91,979	179,485	263,389	83,323	168,696	11,370
$200 to $249	91,891	21,810	70,081	12,329	2,851	9,478	-
$250 to $299	65,412	13,627	51,785	5,436	1,025	4,411	-
$300 to $349	52,249	8,267	43,982	2,641	451	2,190	-
$350 to $399	38,338	3,772	34,566	1,435	217	1,218	-
$400 to $449	26,167	1,658	24,509	809	66	743	-
$450 to $499	17,867	1,007	16,860	466	34	432	-
Subtotal--under $500	563,368	142,120	421,248	266,505	87,967	167,168	11,370
$500 to $599	19,630	953	18,677	334	12	322	-
$600 to $699	10,065	421	9,644	110	4	106	-
$700 to $799	5,627	339	5,288	33	2	31	-
$800 to $899	3,030	31	2,999	9	-	9	-
$900 to $999	1,693	11	1,682	7	1	6	-
Subtotal--under $1,000	603,213	143,675	459,538	266,998	87,986	167,642	11,370
$1,000 and over	1,660	7	1,653	1	-	1	-
Grand Total	604,873	143,682	461,191	266,999	87,986	167,643	11,370

Table 2

Survivor annuitants on the retirement roll as of June 30, 1968

Class of survivor annuitant	Number on the roll	Total annuities (monthly)		Average age in 1968	Average service of deceased (years)
		Amount	Average		
PRIOR TO PUBLIC LAW 854					
SURVIVORS OF DECEASED ANNUITANTS					
Title dependent on designation by retiring employees:					
Widows	29,307	$3,792,350	$129	73.3	28.3
Widowers	103	8,221	80	76.5	22.5
Children	112	6,347	57	59.9	27.8
Other	148	15,486	105	76.5	31.8
Title not dependent on designation by retiring employees:					
Widows	28,761	1,716,910	60	76.5	22.8
Widowers	578	27,773	48	77.1	19.1
Children:					
Spouse surviving	1,700	48,022	28	22.1	19.1
No spouse surviving	441	20,798	47	34.6	23.1
SURVIVORS OF DECEASED EMPLOYEES					
Widows	22,876	2,113,233	92	67.3	18.6
Children:					
Spouse surviving	3,579	93,860	26	19.3	12.7
No spouse surviving	381	16,892	44	26.5	14.4
Total	87,986	7,859,892	89	69.2	23.0
PUBLIC LAW 854					
SURVIVORS OF DECEASED ANNUITANTS					
Title dependent on designation by retiring employees:					
Widows	59,232	$7,858,358	$133	66.8	23.4
Widowers	1,317	113,600	86	63.5	17.9
Children	32	2,477	77	48.7	22.3
Other	146	18,452	128	68.1	29.1
Title not dependent on designation by retiring employees:					
Children:					
Spouse surviving	11,876	623,840	53	15.6	17.6
No spouse surviving	1,169	78,240	67	18.6	17.1
SURVIVORS OF DECEASED EMPLOYEES					
Widows	52,527	6,633,376	126	56.7	19.8
Widowers	109	8,667	80	67.3	16.6
Children:					
Spouse surviving	38,564	1,986,661	52	14.5	16.8
No spouse surviving	2,673	172,540	65	15.6	13.7
Total	167,643	17,496,209	104	46.1	20.1
PUBLIC LAW 85-465					
SURVIVORS OF DECEASED ANNUITANTS					
Widows	4,202	$259,533	$62	80.7	-
Widowers	4	188	47	83.7	-
SURVIVORS OF DECEASED EMPLOYEES					
Widows	7,160	391,071	55	75.6	-
Widowers	4	179	45	78.2	-
Total	11,370	650,971	57	77.5	-
GRAND TOTAL					
SUMMARY BY RELATIONSHIP					
Widows	204,065	$22,764,829	$112	66.6	1/ 22.5
Widowers	2,115	158,628	75	68.1	1/ 18.4
Children	60,527	3,049,677	50	15.7	16.7
Under age 18	44,903	2,231,144	50	15.2	16.0
Students	12,968	679,781	53	19.7	18.1
Disabled	2,512	129,926	52	36.1	22.0
Designated	144	8,826	61	57.4	26.6
Other	292	33,938	116	71.3	30.5
Grand Total	266,999	26,007,072	97	55.1	1/ 21.1

1/ Excludes survivor annuitants under Public Law 85-465, effective Aug. 1, 1958.

Table 3

Employee annuitants added to the retirement roll during the fiscal year ended June 30, 1968

Provision under which retired	Number added to the roll			Total annuities (monthly)		Type of annuity			Average survivor annuity (monthly)	Average contributions	Average age in 1968	Average service (years)	Number with Federal employees' group life insurance
	Total	Men	Women	Amount	Average	Life only	Life, plus survivor annuity						
							Widows or Widowers	Other					
RETIRED UNDER PROVISIONS IN EFFECT PRIOR TO AMENDMENTS BY PUBLIC LAW 854													
Disability	7	4	3	$576	$82	7	-	-	-	$1,178	53.9	20.6	1
Optional, 15-29 years' service, age 60	2	2	-	126	63	1	1	-	$31	-	77.0	19.5	-
5 years' service, immediate annuity	7	5	2	248	35	7	-	-	-	19	66.6	[illegible]	-
5 years' service, deferred annuity	2,626	1,760	866	147,237	56	2,626	-	-	-	1,416	63.6	11.8	-
Voluntary, 25 years' service	2	2	-	225	113	2	-	-	-	1,579	54.5	27.5	-
Members of Congress	2	2	-	348	175	1	1	-	76	7,700	63.0	7.6	-
Transferred from other systems	11	10	1	579	53	11	-	-	-	2,843	62.6	11.3	-
Total	2,657	1,785	872	144,340	56	2,655	2	-	56	1,428	63.7	11.8	1
RETIRED UNDER PROVISIONS AS AMENDED BY PUBLIC LAW 854													
[illegible], 25 years' service, age 48	25	18	7	$11,050	$442	9	16	-	$277	$10,076	49.5	24.8	24
Compulsory, 15 years' service, age 70	3,006	2,066	940	918,472	306	1,215	1,779	12	190	[illegible]	71.3	35.5	2,[illegible]
Disability	15,007	11,307	3,600	3,535,451	236	3,965	11,170	-	117	4,956	53.4	17.7	12,473
Optional, 30 years' service, age 55	5,097	4,932	165	2,330,537	476	1,127	4,150	10	240	8,971	57.6	39.4	[illegible]
Optional, 30 years' service, age 60	5,140	4,372	767	2,643,526	513	1,100	4,023	15	299	9,347	61.4	38.5	[illegible]
Optional, 20-29 years' service, ages 60 and 61	6,153	3,843	2,300	1,893,786	306	3,430	2,715	8	175	7,356	61.3	[illegible]	5,[illegible]
Optional, 15-19 years' service, age 62	11,163	7,002	4,161	2,744,302	246	6,372	4,815	16	146	6,371	65.0	21.7	[illegible]
Optional, 5-14 years' service, age 62	1	1	-	50	50	-	1	-	77	930	[illegible]	[illegible]	-
Optional, 30 years' service, age 50	508	498	9	270,664	536	34	470	1	301	10,936	56.5	[illegible]	456
5 years' service, immediate annuity	890	535	343	67,996	77	387	502	-	46	2,869	64.4	9.8	136
5 years' service, deferred annuity	1,425	669	756	175,156	123	565	856	4	79	3,775	62.9	14.3	-
Involuntary, 25 years' service, age 50	1,064	766	298	259,079	264	788	769	3	136	6,230	55.2	27.4	[illegible]
Voluntary, 25 years' service	1,743	1,385	348	570,464	327	612	1,130	2	184	7,751	58.2	26.9	1,427
Members of Congress	6	5	1	4,463	744	1	5	-	407	27,448	65.2	15.7	2
Total	49,977	36,479	13,493	15,167,948	304	14,795	35,043	64	175	6,308	60.1	23.0	[illegible]
Grand Total	57,579	39,194	14,385	15,317,301	292	17,450	35,086	64	175	6,138	60.3	21.9	[illegible]

Survivor annuitants added to the retirement roll during the fiscal year ended June 30, 1968

Class of survivor annuitant	Number added to the roll	Total annuities (monthly)		Average age in 1968	Average service of deceased (years)
		Amount	Average		
PRIOR TO PUBLIC LAW 854					
SURVIVORS OF DECEASED ANNUITANTS					
Title dependent on designation by retiring employees:					
Widows	1,903	$255,961	$135	73.0	29.6
Widowers	8	713	89	79.2	26.4
Children	-	-	-	-	-
Other	7	562	80	76.0	26.7
Title not dependent on designation by retiring employees:					
Widows	1,066	54,458	51	75.2	21.2
Widowers	41	1,922	47	78.0	18.9
Children:					
Spouse surviving	117	3,182	27	18.2	19.6
No spouse surviving	33	1,506	46	35.0	23.5
SURVIVORS OF DECEASED EMPLOYEES					
Widows:					
With children	-	-	-	-	-
Without children	33	1,407	43	53.5	11.9
Children:					
Spouse surviving	2	24	12	29.0	6.0
No spouse surviving	-	-	-	-	-
Total	3,210	319,733	100	71.2	26.0
PUBLIC LAW 854					
SURVIVORS OF DECEASED ANNUITANTS					
Title dependent on designation by retiring employees:					
Widows	10,532	$1,516,262	$144	63.2	23.9
Widowers	418	37,724	90	61.6	18.1
Children	3	189	63	39.7	26.7
Other	16	2,690	168	66.3	31.5
Title not dependent on designation by retiring employees:					
Children:					
Spouse surviving	2,774	144,680	52	15.5	19.0
No spouse surviving	246	16,447	67	18.1	18.7
SURVIVORS OF DECEASED EMPLOYEES					
Widows:					
With children	2,792	379,760	136	46.1	19.2
Without children	2,906	440,062	152	55.8	21.6
Widowers	17	[illegible]	[illegible]	[illegible]	15.3
Children:					
Spouse surviving	6,693	328,317	49	13.9	18.1
No spouse surviving	479	29,844	62	14.2	14.1
Total	26,669	2,896,806	109	42.1	20.9
PUBLIC LAW 85-465					
SURVIVORS OF DECEASED ANNUITANTS					
Widows	12	$506	$42	75.2	-
Widowers	-	-	-	-	-
SURVIVORS OF DECEASED EMPLOYEES					
Widows	20	615	31	75.1	-
Widowers	-	-	-	-	-
Total	32	1,121	35	75.2	-
GRAND TOTAL					
SUMMARY BY RELATIONSHIP					
Widows	19,262	$2,649,031	$138	61.2	1/ 23.2
Widowers	479	41,190	86	63.3	1/ 18.3
Children	10,347	524,187	50	14.6	18.2
Other	23	3,252	141	69.3	30.0
Grand Total	30,311	3,217,660	107	45.2	1/ 21.4

1/ Excludes survivor annuitants under Public Law 85-465, effective Aug. 1, 1958.

SUMMARY

STATEMENT TO THE COMMITTEE ON FINANCE
UNITED STATES SENATE
BY
THOMAS G. WALTERS, PRESIDENT
NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES

October 2, 1969

The National Association of Retired Civil Employees, of which Thomas G. Walters is President, is a 48-year old non-profit and incorporated organization whose 135,000 plus members are retirees of the United States Government Civil Service.

The Committee is urged to consider, in its deliberations on tax treatment of the elderly, the following items:

- Exemption of the elderly from any surcharge tax.
- Exclusion from the gross income of the first $5000 for a family and the first $3600 for a single person received as Civil Service annuity from the United States Government or any agency thereof.
- Re-establishment of the provision to deduct drug and medical expenses for persons 65 years and older. (Deleted in 1967). S. 1564 introduced by former Senator Everett McKinley Dirksen and now before this committee provides for this restoration for income tax purposes.
- Amendment of Medicare to provide for the payment of prescription drugs outside-of-hospital.
- Amendment of Medicare to provide that provisions (a) and (b) be made available to all Federal annuitants and their survivors.

(End)

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STATEMENT TO THE COMMITTEE ON FINANCE
UNITED STATES SENATE
BY
THOMAS G. WALTERS, PRESIDENT
NATIONAL ASSOCIATION OF RETIRED CIVIL EMPLOYEES

TAX EXEMPTION FEDERAL EMPLOYEE ANNUITANTS AND SURVIVORS

October 2, 1969

Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate
Washington, D. C. 20510

Mr. Chairman and Members of the Committee:

My name is Thomas G. Walters, President of the National Association of Retired Civil Employees (NARCE). This organization was formed February 19, 1921, and has been in continuous operation since that date. We now have over 135,000 members with more than 1100 chapters in every State in the Union, Puerto Rico, Canal Zone, and the Philippines. Our membership is made up exclusively of retirees from the Federal Government and their survivors, and I appear this morning on behalf of our membership plus all other Civil Service annuitants and their dependents in the interest of tax reforms which relate to the treatment of these retired people.

As near as humanly possible, equalization of tax benefits has been the goal of our organization for many years, and I congratulate you, Mr. Chairman, and your committee, for your desire to bring about tax reforms and equalize the tax burden. I am happy that these hearings are being held and that representatives of NARCE are permitted the privilege of appearing before this committee to present the views of our members. We strongly believe that some sectors of our economy can help, but we believe that the elderly should be exempt from any surcharge tax and that taxes should be based on ability to pay.

The members of the House and Senate, especially the members of the House Ways and Means Committee and Senate Finance Committee, are to be congratulated for giving serious consideration to a tax reform bill. We sincerely appreciate the attempt by the House Ways and Means Committee and the membership of the House in endeavoring to make beneficial changes, but we strongly believe that an across-the-board exemption would be more easily understood and would make filing of income tax reports much simpler than any other method of tax relief, especially for the older person.

In the 91st Congress many bills have been introduced to grant across-the-board tax exemptions, and we are firmly convinced that a resolution unanimously adopted at our National Convention in San Francisco, California, in 1968, endorsing the exemption of the first $5000 of Civil Service annuity from Federal income tax was a good one.

Our Association believes that a retiree's family should have a Federal tax exemption of $5000, and a single retiree a tax exemption of $3600. As we grow older, we require more medical attention, more drugs and hospitalization, and with the ever increasing cost of living and maintaining a home, in our opinion the figures of $5000 and $3600 are not unreasonable. Much has been said in the press and by public officials that a family living on less than $3000 per year is living in poverty.

Most annuitants and their survivors are in the low income bracket. According to the latest statistics issued by the United States Civil Service Commission only 986 annuitants receive a monthly annuity of $1000 or more. 281,435 annuitants received less than $200 per month and 231,958 survivor annuitants received less than $200 per month. 110,436 annuitants received less than $100 per month; and 168,288 survivor annuitants received less than $100 per month.

Mr. Chairman and Members of the Committee, we receive hundreds of letters and we are convinced that we are not asking for anything unreasonable when we ask for a tax exemption under Federal Income Tax for retirees in the amount of $5000 for a family and $3600 for a single individual. Because of age and infirmities most of our members find it impossible to secure supplementary employment and to put it bluntly, at the age of most of our retirees, due to mental and physical deterioration many must be placed in nursing homes for which most of the health benefits programs are very limited in their coverage. We can furnish you with hundreds of names and addresses, but for the record I am quoting from two letters that came in the mail to NARCE recently:

> "My husband's annuity is $264 a month and he is 88 years old and I am 82, and due to his mental condition, the doctors have placed him in a nursing home, and the $264 per month nothing like covers the cost." This letter from Alabama.
>
> From the State of Colorado: "With 15 years of service . . ." this lady receives "$107 per month."

It is generally understood that drug and hospital expense for those over age 65 are, on the average, three times higher than those for all Americans, and approximately one-half of all Americans over age 65 are living at or near the poverty line. We have hundreds of cases of members writing us that though they can see the doctor, they can not afford to have their prescriptions filled. To aid these low income retirees, we are urging early consideration of a measure to have prescription drugs covered by Medicare.

With all of our members being retired Federal employees or survivors, we also meet with the problem that many of them are not eligible for Part A or the Hospitalization portion of Medicare. We should greatly appreciate seeing the Medicare law amended so that all persons over 65 would be eligible for both portions of Medicare coverage. I would be happy to furnish any additional information along this line that you desire.

We realize that you have a most complex problem in attempting to bring forth legislation to equalize the great tax burden of this country, but we do feel that the younger people and those that have their life before them, and the larger companies and individuals with tremendous salaries should bear the greater burden of the taxes and make it as light as possible for the senior citizens who have over the years worked hard and paid all taxes required of them. I believe most people are of the opinion that the people of this country who work for a reasonable or small salary, pay a greater percentage of the taxes than any other group. The retirees of the Federal Government paid taxes on their salaries during their working careers and we strongly recommend that we now have some tax relief. We believe that if we had a $5000 tax exemption for a family and $3600 for a single individual it would be a step in the right direction.

Until 1967 we were able to deduct our drug and medical expenses provided we were 65 years of age. We strongly recommend that this provision be re-established as this would mean a great deal to all senior citizens. S. 1564 introduced by the late Senator Dirksen, and referred to this Committee would achieve this.

Mr. Chairman and Members of the Committee, we would like very much to summarize our suggestions as follows:

- Exemption of the elderly from any surcharge tax.
- Exclusion from the gross income of the first $5000 for a family and the first $3600 for a single person received as Civil Service annuity from the United States Government or any agency thereof.
- Re-establishment of the provision to deduct drug and medical expenses for persons 65 years and older. (Deleted in 1967). S. 1564 introduced by former Senator Everett McKinley Dirksen and now before this committee provides for this restoration for income tax purposes.
- Amendment of Medicare to provide for the payment of prescription drugs outside-of-hospital.
- Amendment of Medicare to provide that provisions (a) and (b) be made available to all Federal annuitants and their survivors.

Thanks so much, Mr. Chairman, for giving us the privilege and opportunity of appearing before your Committee.

Thomas G. Walters
President

S U M M A R Y

Presentation by

Miss Vivien Kellems

East Haddam, Connecticut

for the

Senate Committee on Finance, regarding S2794

September 8, 1969

1 - Brief History of the Community Property Law, passed in 1948, which resulted in the penalty tax on single people.

2 - Analysis of this law.

3 - Attempt to test the Constitutionality of the penalty tax.

4 - Bill S2794, Introduced by Senator Eugene McCarthy, August 7, 1969.

5 - Action taken by Miss Kellems to test the constitutionality of the penalty tax.

The first income tax law passed under the Sixteenth Amendment in 1913, consisted of 40 pages. The latest, published July 22, 1968, is 1593 pages. Titles, sub-titles, tables, texts, cross-references, special rules, miscellaneous information, all in very fine print, is one vast labyrinth of gobbledy-gook. Can the most brilliant lawyer, the most adroit and versatile accountant, can the Secretary of the Treasury, can anyone of you gentlemen on the Finance Committee, possibly grasp and understand this fantastic monstrosity we call our Income Tax Law? And this does not include volumes of court decisions, regulations, special rulings, and other paraphernalia.

Congress now proposes to "reform" this hydra-headed monster; close a loophole here, put a patch on there, levy more on one hapless taxpayer, give a crumb of benefit to another. When finished, the whole mess is going to be more incomprehensible and hopeless than it is now.

Naturally the whole thing is shot through with favoritism, injustices and inequities. The most blatant and unconstitutional of them all is the penalty tax against single people.

There is no law that says single people must pay higher income taxes just because they are single. Congress never has, nor does it dare to pass such a law; even this Supreme Court would have to declare it unconstitutional. Then how is it possible that for the past 21 years, the Federal Government has sucked into its cavernous maw billions of dollars from American citizens on the pretext that it is legal to penalize people for not being married?

It was done in 1948 with a sleight-of-hand trick called the Community Property Law which wasn't a Community Property Law at all. That was the excuse given for the wholesale robbery of millions of helpless people.

It all began when the Income Tax Amendment to the Constitution was adopted in 1913, and came about because our laws are derived from two different systems, the Spanish Law and the English Common Law. At the end of the Mexican War, Mexico ceded to the United States that territory now comprising New Mexico, Arizona, California, Idaho and Nevada. As each of these states was admitted to the Union, it embraced most of the English Common Law, but retained those Spanish Laws protecting the rights of the wife to one-half of the property acquired after the marriage, also one-half of the income earned by the husband. These laws were inherited from Mexico which in turn, had adopted them from Spain.

Texas came into the Union by treaty, an independent nation, but Texas had already put the community property laws in her Constitution. Louisiana was acquired by purchase from France, but the French community property law was practically the same as the Spanish, so one more community property state came into the Union.

The rest of the states derived their laws from the English Common Law and gave no such rights to wives. As Senator Connally said, women in many of these states were little better than serfs. In some states it was legal for a man to beat his wife, provided the switch was no thicker than his thumb.

When the first income tax law was passed under the Sixteenth Amendment, the Internal Revenue Service recognized these community property laws and permitted married people in these seven states to split their incomes and pay at a lower rate. Since these first income taxes were very low and exemptions relatively high, the rest of the country paid no attention to this special benefit enjoyed by their sister states. However, after the first world war when income taxes reached astronomical heights, the common law states came to with a bang. How come? Why weren't they entitled to the same tax break?

The first bill to equalize these rates was introduced in Congress in 1921, but went down to ignominius defeat. The community property states refused point blank to extend this lucrative loophole to the rest of the country.

They had a good thing going and didn't propose to give it up. Again and again the common law states tried to pass this bill, but each time they lost. As Senator Fulbright said, these bills were "filibustered to death". Due to the lower taxes paid by married people in the community property states they were sitting pretty; the common law states were paying a disproportionate share of the cost of the Federal Government.

By 1947 the battle lines were drawn and feelings ran high!

The very first bill introduced in the 80th Congress was House Resolution No. 1 - to reduce income taxes. The House passed this bill and sent it to the Senate where Senator McClellan immediately proposed an amendment to pass on the blessings of split income taxes to the rest of the country. By this time five more states, Michigan, Nebraska, Oklahoma, Oregon and Washington had passed community property laws, making a total of twelve such states. Senator McClellan's amendment proposed to bring the other thirty-six states under this protective tax umbrella.

It was a lighted match and fireworks exploded on the Floor of the Senate. Senator McClellan charged that the Community Property states were getting away with murder. He claimed the common law states were paying $500,000,000 a year more than the community property states, an advantage to these twelve states of $175,000,000. He was grieved that Arkansas, his home state, paid $5,000,000 more in federal taxes in 1946 than a community property state of comparable population would have paid. To the distinguished Senator this was an unbearable penalty inflicted upon his state and "the rankest and most unjust discrimination that exists anywhere in our tax laws against three-quarters of the states". "Such a monstrosity in our tax structure" was not to be borne and he demanded "righteous and equitable treatment for simple justice to all American citizens alike." But to Senator McClellan and 99% of that august body, such "righteous and simple" justice did not apply to single people.

Throughout the debate the only words used in referring to the taxpayers were the "citizens" or "people of my state" or of the United States. The words "single people" appear only three times in that whole, lengthy debate that stretched out over months. Senator Milikin rather timidly ventured the opinion that there were other people to be considered. He suggested that there might be "important effects on the distribution of taxes among the different income groups between married and single persons". And at another time, "I am emphasizing that we are dealing with a group problem. Under the Senator's amendment a single person living alone would not benefit. Widows with children would not benefit. Children with dependent parents would not benefit."

But the Senator might just as well have saved his breath. Not one member of that "most exclusive club in the world" even heard the word single. Even widow with children failed to register. Senator McClellan tartly replied, "the bill does perpetuate a group benefit which now accrues, and I am trying to quit perpetuating this group benefit to the community property states." And the rest of the Senators went right on prattling about the "citizens of my state," or the "citizens of the United States," or the "people" of the state or nation. To them there were no single people; everyone was married.

Incredible! Suffering poignantly from "blatant injustice" they were utterly oblivious that they were shunting off onto the frail shoulders of those least able to pay, the whole weight of the burden which they were determined to dump from their own. There was no pretense; it was a straight tax gimmick. It unabashedly gave a tax advantage to one class of taxpayers. One member assured Senator McClellan that the Ways and Means Committee would "consider this matter with the greatest sympathy". To which the Senator from Arkansas replied, "I want a reduction in taxes, not sympathy." He then informed Senator Knowland, "On our present salary ($12,000) I pay $646.00 more Federal tax than does the Senator from California. I need that money for my family as much as does the Senator need that amount of money for his family. All I am asking is that justice be done." The saving on the present Congressional salary is over $4500.00.

It was then suggested that Arkansas could pass its own community property law, but this was not easy. The five states that had passed such laws did so in self-defense with the greatest difficulty. Another state, Pennsylvania, had passed such a law only to have the Supreme Court of Pennsylvania declare it unconstitutional. Community property laws created all kinds of problems affecting estates, domestic relations and commercial credit; they could upset court decisions and cause individual and general chaos. Senator McClellan didn't think much of that idea; the only solution to his problem was a Federal Law; he would settle for nothing less.

At this point Senator Connally invited the Senator from Arkansas to move to Texas and this brought up another sore point. While the Senator couldn't very well move to Texas, that was exactly what a number of his constituents were doing. The town of Texarkana was divided right down the middle by the state line between Texas and Arkansas and many wealthy citizens of Arkansas, whose businesses were in that state, found it profitable to move their homes across the state line to Texas where they happily split their incomes and paid Uncle Sam at the lower rate. Other states lamented loudly that the Community Property states were siphoning off the wealth and business of the non-community property states. They did indeed, have a good thing going!

Senator Fulbright termed it "geographical discrimination" and he challenged any Senator to "cite any other case where we make a distinction and a difference in the tax burden because of citizenship in a particular state or states."

I ask Senator Fulbright, show me any other tax law which makes a distinction and a difference in the tax burden because of the marital condition of the taxpayer?

The bill did not pass in 1947. However, it was one of the first bills passed in 1948. One April 1, 1948 President Truman vetoed it, calling it "inequitable". The very next day Congress passed it over his veto.

It should be made quite clear that this was not a community property law. Not one property law, or any other law, was changed one iota. Not one piece of property, or penny of income changed hands under this law. No wife anywhere received one thing except as she benefited by the tax savings. Everything remained precisely as it was and the husband still owned his income. It was a straight tax gimmick, class legislation and discrimination of the most flagrant sort. There was absolutely no pretense. It was a rich, married taxpayer's bill, the higher the income the greater the percentage of saving. Poor married couples, those receiving $5000 or lower, didn't save a dime. The single taxpayers were left holding the bag. They had to pay at the confiscatory rates of World War II without a penny of relief. Never has a law been passed saying they must pay at these exorbitant rates, but under this so-called community property law, the Internal Revenue Service has arrogated to itself the power to illegally collect billions and billions of dollars from these helpless people.

But more than this, the law gave the rich, married people in the community property states something they had not had before. They could now split all income, including that derived from premarital estates. This they could not do before. But under this law rich, married people in all 48 states could split this income, and thereby save themselves billions of dollars. Add to this the estate tax which permits them to pass on one-half their estate with no tax, while the other half is taxed at the lowest rates, and the picture is complete. They had it made! To finish off the single taxpayer, when he dies 100% of his estate is taxed.

But before his sad demise, one more indignity - the Surtax! Since there wasn't one more thing to tax, Congress taxed a tax. This was not a tax on income, this was a tax on the income tax and again the single people had to bear the brunt of it. 10% for married people, but up and up and up for single people because they have to pay 10% on the penalty they are already paying. In thousands of cases it runs over 14%. I make no comment on this action; the facts speak for themselves.

Has there ever been such rank, discriminatory, unjust, unconstitutional legislation against millions of American citizens? Why? Because they are not married.

There has been one attempt to test the constitutionality of this system. The day after Christmas, 1953, one Mr. Faraco died. The very next year, the income tax of his widow was raised 40% because she was now a single person. Mrs. Faraco resented this unjust penalty for having lost her husband, and brought suit to recover this money in the Tax Court of the United States. The Tax Court refused to consider the constitutional issue, and the case, Antoinette M. Faraco, 29 T C 674 (1958), was appealed to the Court of Appeals for the Fourth Circuit and that court held that the law was constitutional (Faraco v Comm., 261 F 2d 387 (4th Cir., 1958)).

The Court of Appeals stated, page 389:

> "Taxpayer seeks to recover the difference in the tax paid upon her 1954 income and the amount of tax which would have been due if a husband and wife reported the same income and deductions upon a joint return. Permitting married taxpayers to use the split income device of #2 of the 1954 Code, 26 USCA #2, while withholding the privilege from single persons, she says is such an arbitrary and unreasonable discrimination that it cannot be allowed under the Constitution. Classification of taxpayers according to marital status is not unreasonable, however, and there was much reason behind the purpose to equalize the tax burden as it falls upon married couples in common law states in comparison with those in community property states. The fact that the change gave a proportionately greater tax reduction to married couples with large incomes is wholly irrelevant; if the rapid acceleration of the progressive tax rates ran afoul of no constitutional guaranty, a slight withdrawal may not be said to have done so. We find no merit in the taxpayer's contentions."

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In plain English, this decision says that because the increased tax of 40% was so "slight" it did not violate the Constitution, and without doubt, is the most idiotic decision in the whole legal history of the United States. Since when does the amount of damage determine the constitutionality of a law?

That decision was rendered by Judge Clement F. Haynsworth, who has recently been nominated for the Supreme Court.

The Supreme Court refused to rule on this question by denying certiorari (359 U S 925 (1959)) and until it does rule, the constitutionality of the penalty tax on single people simply because they are single, has not been established.

In 1962, Senator Eugene McCarthy, of Minnesota, introduced a bill (S35) which would permit certain persons 35 years of age, or over, to qualify as Head of Household, and pay a lower tax, however, not as low as married persons in the same income tax brackets. There was already a rather nebulous classification, Head of Household, which Congress had added in 1951, to partly still the cries of outrage from indignant taxpayers, but the requirements were so strict that very few people could qualify. For all the relief it afforded, it might as well not have been there.

Senator McCarthy sought to amplify this classification to include many more over-burdened single taxpayers. He got exactly nowhere. His was a lone voice crying in the wilderness. In spite of the lack of understanding and co-operation, even ridicule, the Senator persisted and has reintroduced this bill in each succeeding Congress (88th, 89th, 90th). Convinced of the injustice of the penalty tax and also persuaded that it was unconstitutional, Senator McCarthy felt that it was the best bill that could be considered at that time, since there was such opposition to the whole idea of fairness and justice for single people. Later other Senators joined him in sponsoring the bill and several Congressmen have introduced similar bills in the House of Representatives.

And the Ways and Means Committee recently actually included such a measure in its proposed tax reform bill. This action reflects the change in the political "climate" regarding this tax.

Finally, Senator McCarthy stood on the Floor of the Senate on August 7th, this year, and introduced a bill (S 2794) to abolish the whole unsavory, unconstitutional mess. He was heartily commended by Senator Ribicoff, of Connecticut, who pledged his support of the bill. Senator Ribicoff said, "The Senator from Minnesota has been in the forefront of this fight for many, many years. He has been a lone voice, receiving very little support from anyone else in the executive branch or in the legislative branch. I will certainly be pleased, as a member of the Committee on Finance, to support the Senator's efforts to bring justice in this important field."

It is this bill, Gentlemen, which brings me before your Committee today.

On April 15th, I signed a blank income tax form (1040) and sent it to the Director of Internal Revenue, Andover, Massachusetts. I then wrote the Secretary of the Treasury that I would not pay any more taxes until the Federal Government refunded to me the sum of $73,409.03, taxes which have been illegally collected from me for the past twenty years, plus interest.

From that time, letters have poured in from all over the United States. As their numbers increase, my blood pressure rises! They come from all over the country, from all kinds of people, young people working their way through college, elderly widows trying to make ends meet on meager incomes, school teachers, nurses, telephone operators, stenographers, secretaries, factory workers, and thousands of retired people - a cross section of America. All tell one bitter, heart-breaking story, a crushing penalty tax by an all-powerful, greedy, ruthless government for one reason only, these millions of people are not married.

What began as a simple test of the constitutionality of this tax, has now become a flaming, emotion-packed crusade.

We are creating paupers out of decent, self-respecting, self-supporting American citizens. Read these letters and see if you can stay calm; widows with small children, women whose husbands have been killed in Vietnam and who must pay a penalty for the sacrifice they have made, other widows using the capital of the small estate left by a husband to pay current taxes, one woman living on crackers and tea. Thousands terrified at what the future holds; these are proud people who cannot bear to ask for public assistance, and always the cost of living spiraling ever up and up while their standard of living goes down. Is this what this Committee wants? Is this what the Congress of the United States wants?

I have no quarrel with the split income tax provision, and certainly there isn't any intention to take this tax privilege away from married people. More power to them and to anyone else who can legally save on their taxes! All we single people ask is the same tax break. We want simple justice for single people. And millions of married people agree with me.

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STATEMENT BY ADRIAN H. PEMBROKE, REPRESENTING THE NATIONAL OFFICE PRODUCTS ASSOCIATION AND THE BUSINESS PRODUCTS COUNCIL ASSOCIATION, TO THE SENATE FINANCE COMMITTEE, OCTOBER 2, 1969, AT ITS HEARING ON HR 13270, THE TAX REFORM BILL OF 1969.

SUMMARY OF POINTS

1. Accumulated earnings tax is really a penalty, the liability for which often arises from ignorance, bad advice, misunderstanding, or mistakes in business judgment. It is too complex to be coped with by small corporations. It should be repealed.

2. The accumulated earnings tax is applied only to closely-held corporations which are for the most part small businesses. Large, publicly-held corporations with which small businesses must compete don't have the problem. This gives a competitive advantage to big business in addition to all of its other advantages.

3. Growth must be financed through retained earnings. Financing growth with borrowed capital is unfeasible, particularly in the present high-interest rate money market.

4. The recent decision of the Supreme Court in U. S. v. The Donruss Company has made the taxpayer's life under the accumulated earnings tax even more difficult.

5. If the statute cannot be repealed, amend it to make it easier for small business to live with it.

(a) Overrule in part the Donruss Company decision.

(b) Do something further to alleviate the taxpayer's burden of proof.

(c) Increase the amount of the minimum accumulated earnings credit to reflect the changes in the value of the dollar due to inflation since such credit was fixed at $100,000.

STATEMENT BY ADRIAN H. PEMBROKE, REPRESENTING THE NATIONAL OFFICE PRODUCTS ASSOCIATION AND THE BUSINESS PRODUCTS COUNCIL ASSOCIATION, TO THE SENATE FINANCE COMMITTEE, OCTOBER 2, 1969, AT ITS HEARING ON HR 13270, THE TAX REFORM BILL OF 1969.

My name is Adrian H. Pembroke. I live in Salt Lake City, Utah, where I own and operate a small business. I am a Past President of the National Office Products Association, of Washington, D. C., and a Past President of Business Products Council Association, of Chicago, Illinois. The first of these associations, as its name indicates, represents business organizations engaged in the manufacture, distribution and sale of office products. It has more than 5,000 members. The second association has about 65 member organizations which are dealers in 100 cities in the United States in the products, including office equipment, of a major manufacturer. All the members of each association are independent dealers. Most of them are small, family-owned or otherwise closely-held, corporations. The office products sales business which I operate in Salt Lake City is conducted through a corporation owned by me and my family. It is a member of both of the associations which I have named, and it would be middle-sized among the membership of each association.

I have been authorized by each association to present on its behalf views opposing the retention in the Internal Revenue Code of the provisions relating to Corporations Improperly Accumulating Surplus, Sections 531 to 537, inclusive, or, in the alternative, if such provisions must be retained, some recommendations for changes.

I do not and could not speak as an expert on the accumulated earnings tax or on any other provision of the federal tax laws. However, as a layman who has studied the accumulated earnings tax as it has affected my own business and similarly situated businesses among our membership, I have concluded that it is indeed quite unlike any other tax. Neither the U. S. Corporation Income Tax Return (Form 1120) nor the accompanying instructions for its completion contains any reference to the accumulated earnings tax and there is no separate form for its reporting, nor, unlike the personal holding tax imposed by section 544 of the Code, any schedule for its computation or reporting. In the unlikely event that a corporation should desire to pay the tax voluntarily, its management would be hard put to find out how to do so. This lack of procedure for self-assessment clearly indicates that no corporation is expected to pay the tax voluntarily, and suggests that it is really not a tax but a penalty. And it appears that, too often, liability for the penalty arises from ignorance, bad advice, misunderstanding or mistakes in business judgment rather than from the type of abuse that the provision is designed to prevent. Federal taxation is inherently complex, but a businessman can, on his own or with professional assistance, determine with some degree of certainty the probable tax consequences under many sections of the Internal Revenue Code. Not so with the accumulated earnings tax. A small, closely-held corporation is more often than not confronted with uncertainty

about the consequences of a proposed retention of the earnings of a given year for what he considers to be the reasonable needs of the business. The tests for determining what is a proper or an improper accumulation are so many and varied, and complex, that only the most general and obvious guidelines can be made available by the Internal Revenue Service in its regulations or by the advice of private practitioners of tax law.

Despite the heavy penalty that can be suffered, many executives of small corporations learn of the existence of the accumulated earnings tax only when its imposition is proposed by an Internal Revenue Agent or through information disseminated by trade associations such as ours. Whatever the reason for past ignorance or the circumstances in which such executives first learn of the tax, their reaction is one of shocked disbelief, which is followed quickly by consternation. They have difficulty in appreciating a nearly confiscatory tax which will be imposed if they are unable to make the showings which are necessary under the statute, the Income Tax Regulations and the judicial decisions, if the presumptions against the taxpayer are to be overcome. The contemplation of such a procedure and the possible result can be particularly bitter when the Government has already taken more than half of the corporation's earnings for the year in question and is demanding a large slice of what was left because it was not distributed as dividends and subjected to further tax at the shareholder level.

When the executives of a small corporation learn further that the accumulated earnings penalty is rarely, if ever, imposed on any of the large, publicly-held corporations but has to be coped with only by corporations the ownership and control of which are in a small group of stockholders, there is understandable indignation. The independent dealers in office products who are members of our two associations must compete directly with the giants in the office products manufacturing business who sell their products through company-owned stores. Such corporations have no problems with respect to the retention of earnings for the financing of expansion of facilities or other growth. Retained earnings are the principal source of their financing and, in addition, they have great borrowing power, both with lending institutions and with the public. In contrast, small corporations do not have ready access to the money markets. Such borrowing as they can arrange is frequently, in reality, borrowing by the shareholders who must guarantee repayment of the loan which is made to the corporation. Such borrowing is ordinarly short-term. The retention of earnings is essential for the growth of any business. The large, publicly-held corporation retains its earnings with immunity from any Government action comparable to the accumulated earnings tax and with responsibility only to its shareholders. The small, closely-held corporation can retain profits only within certain ill-defined limits, at the peril of being subjected to a confiscatory additional tax. The competitive

disadvantage is obvious. Such disadvantage is particularly acute at times such as these with the high-interest rate money market which has persisted for some 14 months. This, for practical purposes, precludes even the financing of growth with borrowed capital. It is not surprising that many dealerships in all lines of merchandising have recently been taken over by the manufacturer.

The executives of a small corporation may also be faced with a major problem in the area of planning for the future of the business. Inability to get capital from normal capital sources necessitates primary reliance upon the resources of the corporation or the personal assets of its stockholders. These executives must plan in advance for future expenditures because the amount of capital that is necessary to make, for example, a major modification in a building, in a product line, or to accomplish any sizeable expansion, is more than can be obtained in a short period of time. Thus, the accumulation of capital must be made over a period of years. Executives who look back over the last several years have reason to be very discouraged. This has been a period of almost constant inflation which has recently accelerated. The small businessman whose corporation needs a new building must consider carefully the fact that if it is to be built four years from now, the business must save not what is indicated by present cost estimates, but the additional amount necessary to cover the inevitable price increases with which he will be confronted when construction is commenced. A building which could be built today for

$100,000 may cost $130,000 or $140,000 four or five years from now. We have all watched the price increases in labor generally and in the construction industry specifically, in the cost of money, in the cost of materials, and in the cost of land. This is all very discouraging to the small corporation with aspirations to become larger; and the possibility of being faced with a substantial penalty if the Internal Revenue Service does not agree with his approach in planning for potential future expenditures or obligations adds to the discouragement.

As the small businessmen operating in the corporate form for whom I speak learn more about the scope of section 531 and its administration, they see it rightly or wrongly as a statutory license for Revenue Agents to second-guess the business judgment of management. Many of the questions requiring exercise of business judgment are of an indeterminate nature. For example, management may believe that it is facing a period of industrial upswing when the corporation can expect to do a much greater volume of business which will require more cash, more inventory and the carrying of more accounts receivable. The corporation retains the earnings of a particular year upon the basis of these business forecasts. The upswing does not materialize. Instead, there is a recession which results in lower inventory and receivables and greater liquidity. The working capital forecasts have proved to be wrong. The Revenue Agent, examining the return for the particular year - two or three years later - says,

"It is clear that your corporation didn't need the earnings that it retained," and proposes the imposition of the accumulated earnings tax. Thus, the small businessman has to be right in his business forecasts and judgments, even though most of the economists in the country, including the President's economic advisors, may have been wrong at the same time.

Or, take the case of a retention of earnings for a planned plant expansion or for necessary improvements or repairs. The need may be obvious but management may be doubtful as to when the need should be fulfilled because of rising costs, labor problems, and fears, doubts and uncertainties, shared perhaps by many of the Nation's economists, concerning the general business outlook. Revenue Agents are not at all sympathetic about these fears, doubts and uncertainties, however real and justified. They are interested in seeing evidence of actual commitments, well documented both in the corporate minutes and in contractual arrangements. Again, the small businessman has to be certain or at least venturesome when everyone else is uncertain or cautious about commitments.

Then there is the case of the small corporation which distributes the earnings of a profitable year because of the ever-present threat of the accumulated earnings tax and its heavy penalties. A sharp drop in prices occurs subsequently and the potential profits in current inventories are dissipated. This may lead to insolvency which could have been avoided by the

retention of profits which would have provided an adequate cushion.

Take the actual case of one association member. Fortunately, its management was timely advised that there would be vulnerability to the accumulated earnings tax at the end of the then-current year. The corporation distributed the earnings of that year as dividends and elected to be taxed thereafter under the provisions of Subchapter S of the Code. It is now being told by the manufacturer of the products which it sells that it must prepare for a doubling of sales, which will require the doubling of facilities and of capital requirements. Independent dealerships are continued only by ability to grow and fulfill the demands of the manufacturer. Management of the corporation now wishes that it had a cushion of accumulated earnings at the corporate level to meet this development which was unforeseen at the time it became aware of approaching vulnerability to the section 531 tax. The operation of the statute under its administration and interpretation does not permit the putting aside of amounts for unforeseen developments or in anticipation of a "rainy day." The pitfalls inherent in the retention of earnings without any real purpose to avoid the imposition of tax on shareholders are simply too formidable and complex for the management of small corporations of the type represented by our associations. After a corporation has retained earnings of more than $100,000 it must be prepared to prove with considerable precision what the

reasonable needs of the corporation were at the end of any year when all or a substantial part of the year's earnings were not distributed as dividends. It must now, after the decision of the United States Supreme Court in U. S. v. The Donruss Company, 393 U.S. 297 (1969), establish by a preponderance of the evidence, whatever that means, that tax avoidance with respect to shareholders was not "one of the purposes" for an accumulation. The practical effect of this decision, I am informed by counsel, is that a family corporation such as is typical among the members of our associations, must document in its records such overwhelming proof of the business need for the retention of earnings, and of the plans and commitments for satisfying the need, that avoidance of imposition of tax on shareholders which would have resulted if the earnings had been distributed will clearly appear to have been of minor significance. But, of course, every shareholder is aware that he will pay more tax individually if he receives a dividend than if he does not receive it, and if an amount that has been retained for a purpose which is subsequently determined not to be a reasonable need of the business is large enough, it will be difficult to say honestly that the tax effect at the shareholder level should be disregarded as a purpose which was not significant in the determination of dividend policy.

I am also informed by counsel that the activities of Revenue Agents in the section 531 area have increased substantially

since the handing down of the Donruss Company decision by the United States Supreme Court. From the point of view of the Revenue Agent, this is as it should be and if one should voice objections to the unfairness of a particular application of the accumulated earnings tax, the obvious answer by the Revenue Agent would be that the objection is one that should be made not to him or to the Internal Revenue Service but to the Congress. That is our purpose in making this appearance.

We sincerely believe that this tax, as it applies and as it is administered, is unfair to small, closely-held businesses which must compete with big businesses unaffected by this tax; that it stifles expansion in prosperous times; that it is an obstacle to sound planning and fiscal policy; and that the harm that it does to small business is not compensated for by the prevention of the abuse at which it is aimed. We recommend its repeal.

We are aware that repeal of the statute has been urged at various times since the enactment of the first accumulated earnings tax by the Revenue Act of 1913. Since it has been kept on the books, it is obvious that it has been the belief of the Congress that the accumulated earnings tax performs a legitimate and necessary function in our tax policy. We would hope that the changes in our economy that have been occurring in recent years, particularly due to inflation and increases in interest rates, the increasing disadvantages under which small business competes

with big business, the increasing confusion created by judicial decisions and Internal Revenue Service positions, the decrease in the disparity between corporate rates and individual rates which may be decreasing even further, may be considered valid reasons for repeal of the penalty tax. However, if the Congress, in its wisdom, decides to retain the provision, we would like to see it modified in ways that will make it easier for the executives and other representatives of small corporations to live with it, to make predictions concerning vulnerability to the tax, and to avoid its pitfalls in the never-ending potential of expensive, time-consuming and frustrating controversies with the Internal Revenue Service.

First, we would like to see the statute amended to overrule in part the decision of the Supreme Court in the Donruss case. As herein previously indicated, and as indicated in the dissent by Mr. Justice Harlan in that case, it will be extraordinarily difficult for a taxpayer to prove that the knowledge of tax savings, which will almost always be present when earnings are retained instead of being distributed as dividends, did not play some part, however slight, in the decision not to distribute. The statute should be amended to provide a "but for cause" test which would allow the Government to prevail if it can show, with the aid of the section 533(a) presumption, that taxpayer would not have accumulated the earnings if it had not been for the tax saving at the shareholder level, and which would permit the

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taxpayer to escape the tax if it can show that the earnings would have been accumulated even had no tax saving been possible. Such an approach would give effect to the section 533(a) presumption and enable the imposition of a penalty upon a taxpayer which had a "purpose" to avoid the tax, and, on the other hand, it would afford the taxpayer an opportunity to prove the existence of a purpose "to the contrary."

Without specifying how it may be accomplished, we strongly believe that something further should be done about the burden of proof in accumulated earnings tax litigation, and that the application should not be restricted to Tax Court proceedings. A proceeding which leads to litigation of an accumulated earnings issue starts with a statutory notice which simply states that it has been determined by the Commissioner that earnings of a particular year in excess of the reasonable needs of the business have been retained by the taxpayer (or words to that effect). There is no specification of the facts or conclusions upon which such determination is based. The taxpayer must take it from there and is placed in the position of having to negate the existence of all the possible facts or circumstances upon which the Commissioner may have based his determination. This is too great a burden, particularly for the small corporation with limitations upon the amounts it can spend for legal advice and assistance in so complex an area of the law.

At the very least, we recommend that the amount of the minimum accumulated earnings credit provided for by section 535(c)(2) of the Code be increased substantially. The value of the dollar has been decreased so greatly by inflation since the credit was raised from $60,000 to $100,000 in 1958 that the necessity for a further increase is clearly indicated. When this increase occurred in 1958, the House Committee Report (85th Cong., 2d Sess., H.Rep. No. 2198 (1958) 6) which accompanied HR 8381, amending section 535(c) of the 1954 Code, stated as follows:

> "Your committee has increased this $60,000 minimum accumulated earnings credit to $100,000. The accumulated earnings tax has presented an especially serious problem for small business, because the absence of specific plans frequently makes it difficult for small business to establish the reasonable needs of the business for accumulated earnings. It was in fact this which initially led to the $60,000 minimum credit in prior years. By raising this amount to $100,000, your committee makes allowances for rising costs since this figure was first established and also provides a slightly wider margin of accumulation with respect to which business can be free of worry concerning the accumulated earnings tax. It should be made clear, however, that this increase in the minimum credit is not in any way intended as an indication that accumulated earnings in excess of $100,000 are necessarily subject to this special tax."

The foregoing reasons, which prompted the increase from $60,000 to $100,000 in 1958, apply with even greater force today after ten years of inflation. The amount which a corporation should be permitted to retain with no questions asked

should be equated to the decrease in the value of the dollar.

If the higher brackets of the individual income tax rates are to be lowered, it is assumed that there would be a correlative change in the 27½ percent rate for imposition of the accumulated earnings tax on accumulated taxable income not in excess of $100,000 and in the 28½ percent rate on accumulated taxable income in excess of $100,000, provided by sections 531(1) and (2).

I appreciate very much this opportunity to present views of our association members concerning the accumulated earnings tax.

STATEMENT OF NORMAN TOPPING, PRESIDENT

UNIVERSITY OF SOUTHERN CALIFORNIA

LOS ANGELES, CALIFORNIA

SUMMARY OF PRINCIPAL POINTS

Certain provisions of the Tax Reform Act of 1969 will discourage vital gifts to higher education.

Specific damaging provisions include those relating to gifts of appreciated assets and allocation of deductions; life income trusts; donative sales; short-term trusts; tax and other regulations concerning foundations.

Tax reform can be achieved without harm to independent higher education.

Independent higher education already faces a financial crisis, and giving should be further encouraged by Congress.

* * * * *

Let me first express my appreciation for the opportunity to be heard by the committee out of the scheduled order of subjects. I was required to be in Europe most of last month while these hearings were being held. The matters you are hearing are of such great importance to higher education that I felt I must accept this opportunity to make my views heard.

Independent higher education is vital to our system of society--to our unique way of life in the United States. Congress in the past was right to encourage charitable gifts. In principle, the Tax Reform Act of 1969 also encourages gifts--it includes a provision increasing the ceiling on deductibility. In practice, it will not work to encourage gifts.

You have heard many hours of expert testimony. I will summarize four major points.

1. Gifts of appreciated assets are the major form of gifts above a thousand dollars. They provide more than half of the dollars in gifts to independent higher education. The allocation of deductions provision in the bill before you would severely restrict this kind of gift.

2. Life income trusts would be virtually eliminated. This form of gift has been growing in usefulness during recent years. For the year ending with June, 1968, independent higher education received nearly $45 million in gifts subject to life income or annuity. This is more than twice the estimated additional revenue to the government from the tax reform provisions affecting charitable deductions. Government would benefit very little; private higher education would suffer substantially.

Most independent colleges and universities do not enjoy a huge endowment. Huge funds at Harvard and Yale and at a handful of other fine universities are the exception. The University of Southern California, for example, receives only three per cent of its annual revenue from endowment. Before this bill, we had looked to the life income trust as a major means of increasing this vital guarantee of annual revenue.

3. Donative sale gifts and short-term trusts no longer would be useful means of giving. Additionally, there are retroactove provisions in the bill which will cost us at USC a two-million dollar short-term trust created last May. I am certain other institutions will be similarly deprived.

I think it is important to note that through all these forms of gifts, the donor decreases his spendable income. He does not make money from his gift to higher education or other charitable activities--unlike other kinds of tax preferences.

4. Additionally, many of the provisions regarding foundations would decrease gifts to higher education. Any tax will, of course, decrease the total amount foundations have to give away. Even the 2% tax proposed by the Treasury--let alone the 7.5% provided in the House bill--is significant. Half or more of the $25 million estimated to be produced by a 2% tax would otherwise go to education. For many independent colleges, this loss will be critical.

We oppose the 20% ownership of a corporation provision as unduly restrictive. It would penalize many fine foundations which have acted with great responsibility and are principal benefactors of higher education.

The point is pertinent to certain of the provisions in the Tax Reform Act. They are intended to penalize a few persons or institutions which have abused their privileges, or to make laws equitable where only a relative handful have not paid a fair share. Unfortunately these provisions result in hurting others.

We all favor equitable tax laws. Congress is to be commended for this vital effort to eliminate abuse. But surely these objectives can be achieved without critical damage to independent higher education. Indeed, we do not oppose many of the provisions--for example, those which would insure that everyone would pay a share of taxes--which will serve to eliminate injustice.

Higher education everywhere, and independent higher education especially, is already in a state of financial crisis. Independent institutions have already been forced to become supported by governments. Others may soon be forced to close.

All the statistics--the taxes required to run state systems, the gifts needed by independent institutions, the percentage of actual giving as opposed to the percentage allowable under our present tax laws--all these statistics and others indicate to me that charitable gifts should be encouraged, not made more difficult.

We have created a great nation in large measure owing to our system of combined public and private education. Each complements the other. Each helps to keep the other strong. Where would we be with only one system? Yet that is the very real danger presented by provisions in this Tax Reform Act. Independent higher education can only be weakened, with an even greater burden on government for education as the inevitable result.

I urge this distinguished Committee to create a bill which will continue to aid higher education, one which will make our tax laws equitable without damaging our American way of life.

PART B—ADDITIONAL STATEMENTS

Statement by Ray M. Petersen

for

the Hearings before the Senate Committee on Finance

on

H.R. 13270 - The Tax Reform Act of 1969

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I am Ray M. Peterson, Fellow of the Society of Actuaries, and am presenting this statement as the views of a concerned individual representing only himself. I retired from the service of The Equitable Life Assurance Society of the United States in 1966 as Vice President and Associate Actuary after 43 years of service. Many of those years were devoted to the various aspects of old age retirement programs including actuarial matters, plan design, administration and Federal regulation and income tax treatment.

I appreciate the consideration of the Chairman of your Committee, as conveyed by telegram from Tom Vail, Chief Counsel, in agreeing to accept a statement from me with the assurance that it "will be printed in record and be given same consideration as though delivered orally."

The purposes of this statement are (1) to provide the Committee and the Congress with information relating to what will be demonstrated as situations constituting tax penalties on lifetime income spreading preceded by a background discussion of the nature of retirement provisions and the pseudo-semantic setting that prevails, and (2) to make recommendations that will eliminate such tax penalties. It is believed that such recommendations are consonant with the avowed objectives of H.R. 13270, i.e., to achieve a higher order of equity in taxation.

Among the conclusions of a Task Force Report to the Senate Special Committee on Aging, dated March, 1969, entitled *Economics of Aging: Toward a Full Share in Abundance*, was the following:

> Private group pensions and personal savings--tailored as they are to individual needs, preferences, and financing ability--will continue to be essential supplements to basic social security benefits in the future. The Government should explore and lend support to various methods of promoting and encouraging such supplementary sources of retirement income. (Emph. added)

In the spirit of this recommendation, this presentation is an exploration of methods by which Government can promote "supplementary sources of retirement income" in the private sector by, not encouraging, but merely ceasing to discourage the creation of legitimate retirement income provisions--discouragement that takes the form of a tax penalty on lifetime income spreading for millions of persons in our society.

Nature of Lifetime Income Spreading

Lifetime income spreading is the spreading of a part of income earned during productive years, together with investment earnings thereon, over the non-productive years of retirement. Under legitimate retirement programs, the taxation of the input--contributions from earned income and investment earnings on such contributions--instead of taxation of the output--income during retirement years--constitutes a tax penalty.

Over twenty-five years ago, this truth was expressed by an eminent scholar and recognized tax authority, Dr. Erwin N. Griswold, Dean of Harvard University Law School from 1950 to 1967 and currently Solicitor General of the United States. Writing about the status of employee contributions under employer-instituted pension plans and the contributions set aside by individuals not covered by sucha plan, he had the following to say:

> From the point of view of the employee, a true pension or retirement allowance is income in the year in which he receives the money. An individual knows that his productive capacity will decline before his life ends, if he lives a normal span of life, or longer. Therefore, a part of his activity in his productive years should in fairness and wisdom be attributed to his years of retirement.....What the employee earns during his productive years must, for all practical purposes, be spread over the period of his life. What he receives after his retirement is in reality his income then, for then is when it comes to him. To tax him on it at the top bracket of the graduated rates of his earnings years is an unfair failure to recognize the economic facts of life.....It is hard to find any substantial reason for making a distinction between amounts paid by the employer to provide future pensions and those withheld from the employee for the same purpose. In both cases, the employee's current productive capacity is being utilized to make provision for his retirement. Neither amount is received by the employee any more than the other, for he does not have any more right to obtain presently the amount withheld from his pay than to obtain the additional amount paid by the employer.
>
> ....the tax statutes should be expressly amended so as to provide that amounts paid by an employee to provide bona fide pension benefits after retirement should be deductible from his current income. Such a deduction would have to be guarded to insure that it was available only for the purpose of providing true pension benefits....With such limitations, provision could also be made for the deduction of pension payments made by the self-employed, or by employees whose employers do not provide a pension plan.

....Such a development would not only encourage employees to make provision for their retirement, but would be a recognition of the economic realities of providing for retirement under our present taxing system.[1] (Emphasis added.)

Provision has been made for the self-employed and their employees under the Self-Employed Individual Tax Retirement Act but two major areas of tax discrimination continue to exist: (1) employee contributions and associated investment income by individuals not covered by a qualified or other employer-instituted plan and (2) employee contributions under qualified or other employer-instituted plans. Note that the second category includes members of the Civil Service Retirement System and thus every member of the Congress participating in that System.

The Pseudo-Semantic Setting

It seems difficult to believe that no member of the Congress would fail to support the general proposition that all persons should have the opportunity, through legitimate retirement provisions, to spread the benefit of their productive years over their entire lifetime--and to do it without tax penalties. It is probable that the achievement of this order of tax equity has been unnecessarily obstructed by the language used in describing the income tax treatment of qualified plans. For example, deferred tax treatment is usually referred to as "favorable taxation" by government representatives and by many private pension practitioners. But an examination of the origin of the 1942 legislation will reveal that its objective was not to create a new status of favorable taxation but to impose tax penalties--unfavorable tax treatment--on non-qualified plans--plans or arrangements whose main purpose was tax avoidance. For bona fide retirement income programs, the deferred tax treatment should be described as "tax-penalty free" or non-tax-penalized", not " tax favored." The presence of a "tax incentive" is not enjoyed, rather the absence of a tax disincentive is experienced.

After a careful survey and analysis, this writer reached the following conclusion in a paper published by the Joint Economic Committee of the U.S. Congress:

> The present Federal income tax treatment of employer contributions and investment income for qualified plans, a long existing application of the principle of deferred taxation, is the natural method of treatment since--
>
> (1) There is no workable or equitable alternative for the vast majority of plans as they operate today;

[1] The Tax Treatment of Employees' Contributions to Pension Plans, E.N.Griswold, Harvard Law Review, Volume 57,p. 247 (1943)

(ii) There are persuasive arguments that the treatment conforms to the general principles of tax law; and

(iii) This treatment, as to the employee (in relation to employer contributions), has been accepted for many years, without question and without special legislation, for plans covering Government employees.[2]

Activists in the private pension field have probably contributed to this pseudo-semantic setting by strewing descriptive material and advertising with such terms and phrases as "A Tax Break for the Self-Employed", "Federal income tax benefits", "tax-savings advantages", "a tax shelter can be working for you during your entire business life", "a tax-sheltered fund", and "Tax Sheltered Annuities". Just as programs for the self-employed have been identified by the unemoticanl and non-descriptive term as "H.R.10 Plans", the popularly called "Tax Sheltered Annuities" might better be identified as simply "403(b) plans or programs.

Thus, we have been sealed in the cement of a semantic facade; or, to change the figure of speech, we have been imprisoned by the pervertingprism of parlous parlance!

Magnitude of Tax Penalties

Very little published information has been found to show the magnitude of the effect of taxing the input of retirement provisions instead of taxing the output of such provisions. As indicated, one purpose of this statement is to provide extensive information and analysis of this tax penalty. It can have three sources: (1) taxation of investment income at time of input, (2) taxation of contributions at time of input and (3) taxation of input at the marginal tax rate at time of input instead of at the marginal tax rate at time of output.

To demonstrate the magnitude of such tax penalties, three situations are used: Case I--contributions and investment income taxable at time of input; Case II--contributions taxable at time of input but investment income taxable at time of output; and Case III--contributions and investment income taxable at time of output.

Case I is exemplified by the individual who sets aside a part of his earned income by accumulating funds in a regular savings bank account, mutual fund or other facility, and then arranges for old age income either by purchasing an annuity at age 65 or otherwise providing for regular income payments.

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[2] Old-Age Income Assurance by Lifetime Income Spreading with Deferred Taxation as the Natural Treatment, Ray M. Peterson, F.S.A. A Compendium of Papers on Problems and Policy Issues in the Public and Private Pension System submitted to the Sub-Committee on Fiscal Policy of the Joint Economic Committee, Part III: Public Programs, p.231.

Case II is exemplified by the present status of employee contributions under a qualified plan or additional voluntary contributions by the employee under such a plan.

Case III represents the status of employer contributions under a qualified plan or that of an individual who purchase a 403(b) deferred annuity.

The tax penalty for the individual not covered by an employer-instituted plan, i.e., Case I, is the percentage reduction in income that results from the taxation of contributions and investment income at time of input instead of at time of output, i.e., the excess of Case III income over Case I income divided by Case III income.

The tax penalty for the case represented by the status of employee contributions under a qualified plan, i.e., Case II, is the percentage reduction in retirement income that results from the taxation of contributions at time of input instead of at time of output, i.e., the Excess of Case III income over Case II income divided by Case III income.

In the Appendix hereof, Part I states the assumptions as to interest rates, marginal tax rates, contributions and mortality, Part II gives the mathematical formulas used and Part III displays the results of the calculations, including illustrations of the magnitude of the tax penalty for a wide range of circumstances.

Certain highlights of Tables (A) and (B) of Part III are noteworthy.

1. Although there is a common impression that the lower marginal tax rate that may prevail after retirement is the only factor that produces a difference in the net amount of retirement income that emerges, the fact is that the effect, alone, of shifting the time of taxation from the input period to the output period is very substantial, indeed. For example, consider an individual not covered by an employer-instituted plan (Case I) who invests each year beginning at age 45 in a savings facility that yields 5.5% interest, whose marginal income tax rate is 30% before and after retirement and who arranges to have his accumulated fund, after taxes, paid to him in equal monthly installments over a period corresponding to his expecation of life at age 65. His income, after taxes, will be 2[illegible]2% less than that realized by an employee whose employer makes corresponding contributions with respect to him under a qualified plan (Case III).

Where the marginal tax rate is the same before and after retirement, the illustrations shown range from a tax penalty of 9.4% for contributions commencing at age 55, 4% interest and 20% marginal tax rate to 52.4% for contributions commencing at age 25, 7% interest and 40% marginal tax rate.

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Expressed in another way, the Case III employee realizes 31.9% more retirement income than the Case I employee from a given amount of contributions. For the range of illustrations, the Case III employees realize from 10.4% to 110.0% more income than the Case I employee.

2. If in the individual case cited above, the marginal tax rate after retirement is 20% instead of 30%--a fairly typical situation--and the circumstances are other wise the same, the Case I employee will realize 31.1% less income than the Case III employee.

For the range of illustrations with a 10% difference between pre- and post-retirement marginal tax rates, the tax penalty ranges from 17.0% for contributions commencing at age 55, 4% interest and 20% pre-retirement marginal tax rate to 57.1% for contributions commencing at age 25, 7% interest and a 40% pre-retirement marginal tax rate.

Viewed in another way, the Case III employee realizes 45.1% more retirement income than the Case I employee from a given amount of contributions. For the range of illustrations, the Case III employees would receive from 20.5% to 133.1% more income than the Case I employees.

3. Although the effect of taxing the input of both contributions and investment income is very substantial, as just shown, the effect of taxing the input of contributions alone is also of considerable magnitude. This is the situation that now exists with respect to employee contributions under employer-instituted plans.

To show the magnitude of this effect, consider a contributory plan where employees and the employer are making equal contributions on a "money purchase" basis similar to the plans of the Teachers Insurance and Annuity Association-College Retirement Equity Fund. Assume an employee, and his employer, start to contribute at age 45, interest earnings are at a 5.5% rate and the marginal tax rate before and after retirement is 30%. The retirement income derived from his contributions will be 18.6% less than that produced by the employer's contributions.

Where the marginal tax rate is unchanged after retirement, the illustrations range from a tax penalty of 6.2% for contributions commencing at age 55, 4% interest and a 20% marginal tax rate to 33.3% for contributions commencing at age 25, 7% interest and 40% marginal tax rate.

Expressed in another way, the employer's contributions with respect to the individual case produce 22.9% more income than the employee's contributions. For the range of illustrations, the employer's contributions produce from 6.9% to 49.9% more income.

4. If in the individual case cited in item 3. above, the marginal tax rate after retirement is 20% instead of 30%--a fairly typical situation--and the circumstances are otherwise the same, the employee will realize 23.3% less income from his own contributions than from the employer contributions.

For the range of illustrations with a 10% difference between pre- and post-retirement marginal tax rates, the tax penalty with respect to employee contributions ranges from 14.7% for contributions commencing at age 55, 4% interest and 20% pre-retirement marginal tax rate to 35.7% for contributions commencing at age 25, 7% interest and a 40% pre-retirement marginal tax rate.

Again, viewing another way, the income derived from employer contributions in the individual case will be 30.4% greater than that derived from his own contributions. For the range of illustrations, employer contributions will produce from 17.2% to 55.5% more income than that produced by employee contributions as a result of the difference in tax treatment.

5. Under the majority of contributory plans, the amount of retirement income is not a direct function of the amount of employee contributions but the employee contributes toward an overall formula of benefits (as under the Civil Service Retirement System.) In such cases, the tax penalty illustrated in items 3. and 4. as a lesser amount of income is borne by the employee in the form of increased taxes the value of which is represented by the value of the amount of income reductions occasioned by the tax penalty. Thus, the retirement income could be increased to the extent indicated if the employee were relieved of such taxes and corresponding amounts were channelled into retirement benefits.

6. The higher the marginal income tax rate, the greater the tax penalty.

7. The higher the rate of investment income, the greater the tax penalty.

8. Based on studies not shown, the tax penalty is about the same for men and women for a given retirement age; also, for a given commencing age, the tax penalty increases only moderately as the retirement age becomes older.

Premature Payout Penalty

The tax penalties should be eliminated only with respect to legitimate or bona fide retirement provisions, i.e., programs under which accumulated contributions are either "locked-in" so they can be availed of only at retirement as income (or lump sum settlement) or are subject to a "premature payout penalty" if taken in cash before retirement.

The premature payout penalty should approximately offset the gain that would otherwise be enjoyed from taxing contributions and investment income, or investment income alone, as the case may be, at time of output instead of at time of input. In Tables (C) and (D) of Part III of the Appendix, an illustrative analysis of this gain is shown where contributions are made without interruption.

Where both contributions and investment income are involved, Table (C), the analysis supports a penalty of 1/2% or 2/3% for each year of contribution. Thus, for ten years of contribution, it would be 5% or 6 2/3%. The uniform 10% increase in tax under H.R. 10 plans for "premature distributions" applicable to owner-employees amounts to 3% of the distribution for a 30% marginal tax rate, 4% for a 40% tax rate, and so on.

Where only investment income is involved, Table (D), the analysis supports a penalty, for each year of contribution, of 1/4% of the excess of the amount withdrawn over the sum of contributions. Thus, for ten years of contribution, the penalty would be 2 1/2% of such excess.

An interesting parallel to the tax treatment of investment income with respect to employee contributions under qualified plans is found in the deferred tax treatment of investment income under a "locked-in" arrangement offered for special savings accounts by at least one New York City bank and a Long Island Bank. The tax deferment is based on the principle of constructive receipt and not on any special legislation such as applies to "qualified" plans. Under this arrangement, interest on deposits is guaranteed by one bank for any selected period of years up to thirteen or so, subject to no right of withdrawal of capital or interest for the depositor but the bank could permit withdrawal in accordance with Section 217.4(d) of Regulation Q of the Board of Governors of the Federal Reserve System. This section is captioned: "Payments in emergencies." The bank has recieved an opinion form a qualified tax attorney that income tax on interest accumulations is not payable until the pre-selected maturity date. The opinion asserts that the interest is not constructively received, as defined by Treasury Regulation 1.451-2(a), since "the taxpayer's control of its receipt is subject to substantial limitations or restrictions." Also, accumulated interest on the deposit has no "cash equivalent" that would make it currently taxable.

Recommendations for Tax Reform

In order to eliminate the tax penalties on lifetime income spreading identified in the foregoing pages, it is recommended that the Internal Revenue Code be amended to effect the following changes:

1. For employees not covered by an employer-instituted plan (or who are covered by a meager plan), make contributions from earned income that are applied to a bona fide retirement income arrangement tax-deductible and defer tax on investment income on such contributions until retirement benefits are received provided that the accumulated contributions are "locked-in" either absolutely or practically by a "premature payout penalty" if taken in cash before retirement, i.e., a condition similar to that which applies to owner-employees under H.R. 10 plans. (The Registered Retirement Savings Plan in Canada is a similar program.)

The following advantages would be gained by such a measure:

(i) The discrimination against employees not covered by an employer-instituted plan would be eliminated;

(ii) Such employees would have the opportunity to share in the growth of the economy through the purchase of variable annuity contracts or the use of other facilities for savings accumulations such as are now available to participants in H.R. 10 plans;

(iii) Such employees, who are paying taxes to provide pensions for public employees with tax deferment features, would have similar opportunity to provide for themselves without tax penalties;

(iv) By opening the door for the creation of non-tax-penalized programs for the millions who have not had the chance to participate in employer-instituted plans, an opportunity, at least and at last, would be provided to have 100% pension coverage in the private sector; and

(v) Insurance companies, banks, mutual funds and other funding instrumentalities would be encouraged to extend their services by effective sales promotion activities to the "forgotten man" -- the "man-in-the-street".

2. For employees who are contributing under an employer-instituted plan, make such contributions tax-deductible (including voluntary additional contributions), provided such accumulated contributions are "locked-in" absolutely or practically by a "premature payout penalty" if withdrawn before retirement.

The following advantages would be gained by such a measure:

(i) Discrimination against employee contributions, vis-a-vis employer contributions, would be eliminated;

(ii) The present discouragement of contributory plans would be discontinued;

(iii) The prospect of greater benefits would be enhanced since the level of benefits for contributory plans is generally higher than that for non-contributory plans;

(iv) Vested benefits, derived from employer contributions, now frequently lost by withdrawal of employee contributions upon employment termination, would be preserved. (A good or, perhaps, disturbing example is the experience under the Civil Service Retirement System); and

(v) Contributing employees would have identifiable and fully vested equities that are in terms of dollars and that would properly be considered by employees as their personal savings for retirement purposes.

Associated with these two proposed amendments, it may be desirable to establish a reasonable limit on the aggregate amount of retirement income derived from all sources to which deferred taxation applies. It is suggested that consideration be given to a limit equal to 75% of the average earned income of the last five years of full employment and that a special income tax be imposed on any amount in excess of such limit.

Concluding Observations

In the event of continued inflation, the taxation of the input of retirement provisions instead of the output at a later date--perhaps many years later--results in the payment of taxes of greater purchasing power and, in effect, an additional tax penalty that is not reflected in the figures here presented.

The recommended amendments will stimulate additional savings and thus increase the supply of capital in the years ahead. In such years, the prospect is that expanded welfare programs and social security benefits will produce spending rates that will have an inflationary potential since the marginal propensity to consume of the recipients will tend to be greater than that of those who pay the taxes to provide the funds for such purposes. Thus, the economic effect of these recommendations could be an important influence in combatting inflationary pressures.

As noted, the higher the marginal tax rate, the greater the tax penalty. But, recalling Dr. Griswold's words that "To tax him on it at the top bracket of the graduated rates of his earnings years is an unfair failure to recognize the economic facts of life", then, the higher the individual's top bracket, the more unfair the situation. It is a fair principle that the greater the injury, the greater the recompense deserved. Consequently, there is no justification for a demagogic declaration that elimination of the tax penalty constitutes favoritism to those in the higher income brackets.

Is it too much to say that if the magnitude of these tax penalties on legitimate old age savings provisions was generally know by the millions of employees not covered by employer-instituted plans but many whom are struggling with old-age provisions on their own, a new tidal wave of the tax revolt could engulf the Congress?

Is it too much to say that if the magnitude of the discrimination against employer-instituted plans where employees share the cost vis-avis plans where the employer pays all the cost was widely known, the new tidal wave of tax revolt could be reinforced by the protests of the millions of such contributing employees including participants under the Civil Service Retirement System?

May we hope that the truths here presented will produce actions resulting in tax justice? As Benjamin Disraeli said: "Justice is truth in action."

(i)

APPENDIX -- Part I

ASSUMPTIONS

Contributions

Attained Ages	Scales of Contribution (yearly amount) A	B	C
25-29	$ 600	$ 750	$1,000
30-34	700	900	1,250
35-39	800	1,200	1,500
40-44	900	1,500	2,000
45-49	1,000	1,800	2,500
50-54	1,100	2,200	3,250
55-59	1,200	2,600	4,000
60-64	1,300	3,000	5,000

These may be taken as 10% of a yearly salary or earnings that is ten times the amount of the contribution. The different Scales are distinguished by the salary level and by the rate of increase.

Marginal Income Tax Rates

	Scale of Contributions A	B	C
Pre-retirement	20 %	30 %	40 %
Post-retirement	20 %	30 %	40 %
	15 "	25 "	35 "
	10 "	20 "	30 "
	5 "	15 "	25 "

Interest Rates 4 %, 5.5 % and 7 %.

Retirement Age and Sex Males at Age 65.

Mortality After Retirement Ga 1951 Mortality Table (without projection)

APPENDIX -- Part II

FORMULAS

A. Annual Retirement Income

Definition of Symbols

RI(I), RI(II) and RI(III): annual retirement income, after tax, for Cases I, II and III, respectively.

t_a and t_r: pre-retirement and post-retirement marginal income tax rates, respectively.

i: annual rate of investment earnings before tax.

j: annual rate of investment earnings after tax, i.e., $(1-t_a)\cdot i$.

$C_r^{(i)}$ and $C_r^{(j)}$: accumulations of contributions to retirement age at rates i and j, respectively.

C_r: sum of contributions to retirement age, without interest.

$\bar{a}_m$: continuous life annuity value for retirement age m at interest rate i.

$\mathring{e}_m$: complete expectation of life for retirement age m.

Case I

$$RI(I) = (1-t_a)\cdot C_r^{(j)}\cdot\left[\frac{(1-t_r)}{\bar{a}_m} + \frac{t_r}{\mathring{e}_m}\right]$$

If $t_r = t_a$,

$$RI(I) = (1-t_a)\cdot C_r^{(j)}\cdot\left[\frac{(1-t_a)}{\bar{a}_m} + \frac{t_a}{\mathring{e}_m}\right]$$

Case II

$$RI(II) = (1-t_a)\cdot\left[\frac{(1-t_r)\cdot C_r^{(i)}}{\bar{a}_m} + \frac{t_r\cdot C_r}{\mathring{e}_m}\right]$$

If $t_r = t_a$,

$$RI(II) = (1-t_a)\cdot\left[\frac{(1-t_a)\cdot C_r^{(i)}}{\bar{a}_m} + \frac{t_a\cdot C_r}{\mathring{e}_m}\right]$$

Case III

$$RI(III) = \frac{(1-t_r)\cdot C_r^{(i)}}{\bar{a}_m}$$

If $t_r = t_a$,

$$RI(III) = \frac{(1-t_a)\cdot C_r^{(i)}}{\bar{a}_m}$$

APPENDIX — Part II (con.)

B. Amount of Accumulated Contributions for n Years, After Tax.

$C_n^{(i)}$ and $C_n^{(j)}$: accumulation of contributions for n years at rates i and j, respectively, where $j = (1-t_a)\cdot i$.

C_n: sum of contributions for n years without interest.

Case I $(1-t_a)\cdot C_n^{(j)}$

Case II $(1-t_a)\cdot \left[(1-t_a)\cdot C_n^{(i)} + t_a\cdot C_n\right]$

Case III $(1-t_a)\cdot C_n^{(i)}$

C. Analysis of Effect of Lower Post-Retirement Marginal Tax Rate Than Pre-Retirement Marginal Tax Rate.

A lower post-retirement marginal tax rate produces additional income that can have three elements which are related to
(i) investment income earned during retirement years,
(ii) investment income earned prior to retirement, and
(iii) contributions.

In the following formulas,

I_r, II_r and III_r represent the retirement income for Cases I, II and III, respectively, where t_r is less than t_a.

I_a, II_a and III_a represent the retirement income for Cases I, II and III, respectively, where $t_r = t_a$.

$$\text{Item (i)} = (I_r - I_a) = (t_a - t_r)\cdot(1-t_a)\cdot\left[\frac{C_r^{(j)}}{\ddot{a}_m} - \frac{C_r^{(j)}}{\ddot{a}_m}\right]$$

$$\text{Item (ii)} = (II_r - II_a) - (I_r - I_a)$$

$$= (t_a - t_r)\cdot(1-t_a)\cdot\left[\frac{C_r^{(i)} - C_r^{(j)}}{\ddot{a}_m} + \frac{C_r^{(j)} - C_r}{\ddot{a}_m}\right]$$

$$\text{Item (iii)} = (III_r - III_a) - (II_r - II_a)$$

$$= (t_a - t_r)\cdot\left[\frac{t_a\cdot C_r^{(i)}}{\ddot{a}_m} + \frac{(1-t_a)\cdot C_r}{\ddot{a}_m}\right]$$

The sum of Items (i), (ii) and (iii), i.e., $(III_r - III_a)$,

$$= (t_a - t_r)\cdot\frac{C_r^{(i)}}{\ddot{a}_m}$$

In comparing Cases I, II and III, only Items (ii) and (iii) become involved.

(iv)

APPENDIX -- Part III

Table (A)

TAX PENALTY Arising from Taxation of Contributions and Investment Income at Time of Input (instead of at Time of Output) for Employees Not Covered by an Employer-Instituted Plan.

Commencing Age	4.0% Interest Contribution Scale A	B	C	5.5% Interest Contribution Scale A	B	C	7.0% Interest Contribution Scale A	B	C
	Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 0%								
25	20.3%	26.7%	33.0%	27.3%	35.6%	43.2%	34.0%	43.7%	52.4%
35	16.8"	22.9"	28.5"	22.4"	30.3"	37.1"	27.7"	37.0"	44.8"
45	13.1"	18.6"	23.6"	17.3"	24.2"	30.5"	21.2"	29.4"	36.7"
55	9.4"	13.7"	17.9"	12.1"	17.7"	22.9"	14.6"	21.2"	27.3"
	Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 5%								
25	23.8%	30.6%	37.1%	30.3%	38.7%	46.5%	36.5%	46.2%	54.9%
35	20.5"	27.0"	32.9"	25.6"	33.6"	40.7"	30.4"	39.8"	47.8"
45	17.0"	22.8"	28.3"	20.6"	27.9"	34.5"	24.1"	32.5"	40.1"
55	13.5"	18.2"	23.0"	15.7"	21.6"	27.4"	17.8"	24.7"	31.2"
	Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 10%								
25	27.0%	33.9%	40.7%	32.9%	41.4%	49.3%	38.7%	48.4%	57.1%
35	23.8"	30.5"	36.8"	28.4"	36.6"	43.9"	32.8"	42.3"	50.4"
45	20.4"	26.5"	32.4"	23.6"	31.1"	38.0"	26.7"	35.3"	43.0"
55	17.0"	22.2"	27.4"	18.9"	25.1"	31.2"	20.7"	27.8"	34.6"
	Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 15%								
25	29.8%	36.9%	43.8%	35.3%	43.8%	51.8%	40.6%	50.4%	59.0%
35	26.8"	33.6"	40.1"	30.9"	39.2"	46.6"	35.0"	44.4"	52.6"
45	23.5"	29.8"	36.0"	26.3"	33.9"	41.0"	29.1"	37.7"	45.6"
55	20.2"	25.7"	31.2"	21.8"	28.2"	34.5"	23.2"	30.5"	37.5"

$$\text{Tax Penalty} = \frac{RI(III) - RI(I)}{RI(III)}$$

(v)

APPENDIX -- Part III (con.)

Table (B)

TAX PENALTY Arising from Taxation of Contributions of Employees at Time of Input (Instead of at Time of Output) for Employees Covered by an Employer-Instituted Plan.

Commencing Age	4.0% Interest Contribution Scale A	B	C	5.5% Interest Contribution Scale A	B	C	7.0% Interest Contribution Scale A	B	C
Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 0%									
25	13.4%	19.1%	25.0%	15.7%	22.7%	29.9%	17.3%	25.2%	33.3%
35	12.0"	17.5"	22.8"	14.4"	21.0"	27.5"	16.1"	23.6"	31.0"
45	10.4"	15.2"	20.0"	12.6"	18.6"	24.4"	14.3"	21.1"	27.9"
55	8.2"	12.3"	16.3"	10.2"	15.2"	20.2"	11.7"	17.6"	23.3"
Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 5%									
25	15.3%	21.5%	27.9%	17.0%	24.4%	31.8%	18.1%	26.3%	34.6%
35	14.4"	20.3"	26.1"	16.0"	23.0"	29.9"	17.2"	25.0"	32.7"
45	13.2"	18.5"	23.8"	14.8"	21.1"	27.4"	16.0"	23.1"	30.2"
55	11.7"	16.3"	20.9"	13.1"	18.5"	24.0"	14.2"	20.3"	26.5"
Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 10%									
25	17.1%	23.7%	30.4%	18.1%	25.8%	33.5%	18.8%	27.2%	35.7%
35	16.5"	22.7"	28.9"	17.5"	24.8"	32.0"	18.2"	26.3"	34.2"
45	15.7"	21.4"	27.1"	16.7"	23.3"	30.0"	17.4"	24.8"	32.2"
55	14.7"	19.7"	24.8"	15.7"	21.4"	27.3"	16.3"	22.7"	29.3"
Pre-Ret. Marg'l Tax Rate minus Post-Ret. Marg'l Tax Rate: 15%									
25	18.6%	25.5%	32.5%	19.1%	27.0%	34.9%	19.4%	28.0%	36.6%
35	18.3"	24.8"	31.4"	18.8"	26.3"	33.8"	19.2"	27.4"	35.5"
45	18.0"	23.9"	30.0"	18.4"	25.3"	32.2"	18.8"	26.3"	33.9"
55	17.5"	22.7"	28.1"	17.9"	23.9"	30.1"	18.3"	24.9"	31.7"

$$\text{Tax Penalty} = \frac{RI(III) - RI(II)}{RI(III)}$$

(vi)

APPENDIX -- Part III (con.)

Table (C)

GAIN from Taxing Contributions and Investment Income at One Time at End of Accumulation Period instead of Tax at Time of Input, as Percentage of Gross Accumulation

(Ratio of (a) excess of after tax Case III accumulation over after tax Case I accumulation to (b) before tax Case III accumulation.)

Commencing Age	Period Contributions Made and Accumulated				
	5 yrs.	10 yrs.	20 yrs.	30 yrs.	40 yrs.
	Scale A Contributions (20% MTR)--5.5% Interest				
25	2.15%	4.25%	8.53%	12.93%	17.42%
35	2.15"	4.29"	8.67"	13.17"	
45	2.15"	4.31"	8.75"		
55	2.15"	4.32"			
	Scale B Contributions (30% MTR)--5.5% Interest				
25	2.81%	5.46%	10.25%	14.93%	19.53%
35	2.81"	5.41"	10.46"	15.37"	
45	2.81"	5.44"	10.64"		
55	2.80"	5.51"			
	Scale B Contributions (30% MTR)--7.0% Interest				
25	3.54%	6.92%	13.09%	19.13%	25.0%
35	3.54"	6.86"	13.41"	19.64"	
45	3.54"	6.89"	13.55"		
55	3.54"	6.98"			

Suggested Premature Payout Penalty

	Period Contributions Made and Accumulated				
	5 yrs.	10 yrs.	20 yrs.	30 yrs.	40 yrs.
1/2% for each year of contribution	2.50%	5.00%	10.00%	15.00%	20.00%
or					
2/3% for each year of contribution	3.33%	6.67%	13.33%	20.00%	26.67%

to be applied to the total amount paid out.

APPENDIX — Part III (con.)

Table (D)

GAIN from Taxing Investment Income at One Time at End of Accumulation Period instead of Taxing at Time of Input, as Percentage of Excess of Gross Accumulation over Sum of Contributions

(Ratio of (a) excess of after tax Case II accumulation over after tax Case I accumulation to (b) excess of before tax Case III accumulation over sum of contributions without interest.)

Commencing Age	Period Contributions Made and Accumulated				
	5 yrs.	10 yrs.	20 yrs.	30 yrs.	40 yrs.
	Scale A Contributions (20% MTR) --5.5% Interest				
25	0.83%	2.01%	4.50%	7.18%	10.00%
35	0.83"	2.02"	4.55"	7.28"	
45	0.83"	2.02"	4.58#		
55	0.83"	2.03"			
	Scale B Contributions (30% MTR)--5.5% Interest				
25	0.94%	2.27%	4.89%	7.53%	10.21%
35	0.94"	2.26"	4.94"	7.67"	
45	0.94"	2.26"	4.98"		
55	0.90"	2.28"			
	Scale B Contributions (30% MTR)--7.0% Interest				
25	1.19%	2.90%	6.31%	9.02%	13.34%
35	1.19"	2.88"	6.51"	9.97"	
45	1.19"	2.89"	6.43"		
55	1.19"	2.92"			

Suggested Premature Payout Penalty

	Period Contributions Made and Accumulated				
	5 yrs.	10 yrs.	20 yrs.	30 yrs.	40 yrs.
1/4% for each year of contribution	1.25%	2.50%	5.00%	7.50%	10.00%

to be applied to the excess of the total amount paid out over the sum of the contributions without interest.

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